INVESTING IN THE FUTURE: MINORITY OPPORTUNITIES AND THE THRIFT SAVINGS PLAN

HEARING

BEFORE THE

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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INVESTING IN THE FUTURE: MINORITY OPPORTUNITIES AND THE THRIFT SAVINGS PLAN

THURSDAY, JULY 10, 2008

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2247, Rayburn House Office Building, Hon. Danny K. Davis (chairman of the subcommittee) presiding.

Present: Representatives Davis, Cummings, Norton, Sarbanes, and Jordan.

Staff present: Lori Hayman, counsel; William Miles, professional staff member; and Marcus A. Williams, clerk.

Mr. DAVIS OF ILLINOIS. The subcommittee will now come to order.

Although the ranking member hasn't arrived yet, I expect him to come momentarily, and given the fact that I grew up in an environment where punctuality was the essence of being, or at least my father thought so, we will go ahead and begin.

Welcome, Ranking Member Marchant, members of the subcommittee, hearing witnesses, and all those in attendance to the Subcommittee on the Federal Workforce, Postal Service, and District of Columbia's hearing entitled, "Investing in the Future: Minority Opportunities and the Thrift Savings Plan."

The Chair, ranking member, and subcommittee members will each have a 5-minute period to make opening statements, and all Members will have 3 days in which to submit statements for the record. Hearing no objection, so is the order.

I will begin with an opening statement.

We welcome Mr. Jordan. Mr. Jordan, how are you doing?

Mr. JORDAN. Good morning.

Mr. DAVIS OF ILLINOIS. Today's hearing is intended to examine ways to increase minority participation in the management of Thrift Savings Plan [TSP] Funds and to explore why the Federal Government uses passive management strategies versus active management of TSP funds.

The TSP is the Federal Government's retirement plan, similar to private employer's 401(k) plans. The TSP has over $224 billion under its management. The Plan is unique because, unlike other Federal Government programs, it does not receive any appropria-

tions of taxpayer money, nor does it have a public purpose, and all decisions must be made for the exclusive benefit of TSP participants who invest in the program. This gives participants the confidence that the money invested will only be used in their interest and they will not be charged astronomical fees. By law, TSP stock and bond funds must be passively managed index funds. Passive management funds seek to replicate the broad markets, not beat them, often creating savings for participants because of their traditionally lower fees.

The debate over minorities participating in the TSP funds has been a concern for quite some time; yet, the issue came to the forefront during last year's Congressional Black Caucus legislative conference. The executive director of the Federal Retirement Thrift Investment Board revealed that there are minority firms with talent in long-term financial management. However, most of these firms gravitate toward the active fund management business, which is not an investment strategy of the TSP. Research by the TSP indicates that there may be only one minority-owned firm that deals with passive-management of index funds.

Today's hearing will examine ways to increase minority access and the possibility of increased profitability to members of the Plan because of diversification to active management strategies. Several ideas will be discussed today to try to achieve this goal, including: one, minority firms using passive fund strategies so they can participate in the management of TSP funds; two, minority firms applying to participate in Barclays minority program; and, three, TSP beginning to operate using active funds to increase profitability and minority access.

The debate about active versus passive management of TSP is not a new concept. Today we will discus some of the viable options and explain why the TSP operates as it currently does, and why some firms feel that it is time for the TSP to leap into the future and change its management style of TSP funds.

I thank all of the witnesses in attendance and we look forward to your testimony.

[The prepared statement of Hon. Danny K. Davis follows:]

STATEMENT OF CHAIRMAN DANNY K. DAVIS
AT THE SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA
HEARINGS ON

INVESTING IN THE FUTURE: MINORITY OPPORTUNITIES AND THE THRIFT SAVINGS PLAN
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exclusive benefit of TSP participants, who invest in the program. This gives participants the confidence that the money invested will only be used in their interest and they will not be charged astronomical fees. By law TSP stock and bond funds must be passively-managed index funds. Passive management funds seek to replicate the broad markets, not beat them, often creating savings for participants because of their traditionally lower fees.

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it currently does and why some firms feel that it is time for the TSP to leap into the future and change its management style of TSP funds.

I thank the witnesses in attendance and look forward to your testimony.

Mr. DAVIS OF ILLINOIS. I will now yield to Mr. Jordan for any comments that he might have.

Mr. JORDAN. I thank the chairman.

Today's hearing will take a look at the extent to which minority-owned firms are involved in management of the Thrift Savings Plan funds. For most Federal employees, these funds are a critical component to their retirement plans and, as such, represent a significant positive asset for recruitment and retention of talented civil servants.

The Federal Retirement Thrift Savings Investment Board has managed the funds of these Federal employees in such a manner as to ensure independence, reasonable cost, and transparency. Any efforts to modify that system must first seek to maintain and enhance these characteristics.

It is also important to recognize that the funds controlled by this fund are first and foremost someone else's money. These funds belong to the women and men who have earned them through their service to this country. There may be ways to improve the operation of this fund, but Congress should always keep in mind that it isn't our money. That doesn't mean we can't suggest changes, but the desires and personal goals of the civil servants should always be our guiding principle in making these sort of changes.

I look forward to the testimony of the witnesses today and want to thank the chairman for scheduling the hearing.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Jordan.

Now I would like to ask Representative Norton if she has some opening remarks.

Ms. NORTON. I thank the chairman for this hearing. There are two ways to look at this hearing; to look at what the TSP is doing generally and also look at it as a continuation of the chairman's concern for equal opportunity when Federal dollars are at stake or Federal employment is involved.

We have a competitive process. We are dealing here, at least when it comes to firms, with an area that has been traditionally closed to minority firms; indeed, has discriminated against them. So there is no wonder that this is one of those areas in which we would want to make sure that minority firms understood the competitive process of the Federal Government and that we reached out to encourage their participation in an area that is one that did not welcome them, traditionally, in this government and in this society.

We have to satisfy ourselves that is being done, particularly when you consider the growing number of employees who contribute to the fund who are people of color. We want to make sure that we have done all that we can do to ensure that every part of our government has welcomed all to participation. This may be a difficult part; therefore, it requires some specific action; perhaps action that has not yet been taken, but we will see.

I thank you again, Mr. Chairman.

Mr. DAVIS OF ILLINOIS. Thank you very much, Representative Norton.

We will now go directly to our witnesses. Before swearing them in, let me just introduce our first panel.

Our first panel is Mr. Greg Long, who is the Executive Director of the Federal Retirement Thrift Investment Board. The Board is responsible for administering the Thrift Savings Plan, which is currently the contribution fund for Government employees.

Thank you very much, Mr. Long, for being here.

Our second witness is Mr. Michael Sobel. Mr. Sobel is the managing director and head of U.S. Equity Trading for Barclays Global Investors, which is the management company responsible for the outside management of TSP funds.

Gentlemen, is it our tradition that witnesses be sworn in. If you would stand and raise your right hands.

[Witnesses sworn.]

Mr. DAVIS OF ILLINOIS. The record will show that the witnesses answered in the affirmative.

Again, gentlemen, we are pleased that you are here with us. We would ask that you summarize your statement in 5 minutes. We generally are guided by the green light, although we don't always adhere totally to it. But the green light indicates that you have 5 minutes. When it gets yellow, you are down to 1 minute; and, of course, the red light means that you should summarize your statement and then we will go into questions.

Let me thank you again, and we will begin with Mr. Long.

STATEMENTS OF GREG LONG, EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD; AND MICHAEL SOBEL, MANAGING DIRECTOR AND HEAD OF U.S. EQUITY TRADING, BARCLAYS GLOBAL INVESTORS

STATEMENT OF GREG LONG

Mr. LONG. Chairman Davis and members of the subcommittee, my name is Greg Long, and I am the Executive Director of the Federal Retirement Thrift Investment Board. The five members of the Board and I serve as the fiduciaries of the Thrift Savings Plan for Federal employees.

The TSP is the largest defined contribution retirement plan in the world. Individual accounts are maintained for more then 3.9 million Federal employees, members of the uniformed services, and retirees. As of June 30th, the TSP totaled $226 billion in assets.

Your letter of invitation explained that the purpose of this hearing is to examine the passive investment strategy used in the TSP and explore ways to increase minority participation management of the TSP. I will address both of these matters in my statement.

The TSP was created by Congress in the Federal Employees Retirement System Act of 1986, following 3 years of study and hearings by the House and Senate committees of jurisdiction. The record of these proceedings shows that the committees received input from pension experts, academics, employee representatives, the financial services industry, and the Reagan administration. Significant assistance was also provided by the Congressional Research Service and GAO.

Various investment approaches were considered and, ultimately, the House and Senate decided on a passive investment policy for the TSP. Passive management in the TSP is achieved through the use of index funds. All of the stocks in an index are purchased.

There is no "active" attempt to out-perform the index through specific stock selection.

The following passage from the Joint Explanatory Statement of the Committee of Conference explains how the conferees themselves described the crucial nature of this decision: "Most importantly, the three funds authorized in the legislation are passively managed funds, not subject to political manipulation. A great deal of concern was raised about the possibility of political manipulation of large pools of thrift plan money. This legislation was designed to preclude that possibility. Concerns over the specter of political involvement in the thrift plan management seem to focus on two distinct issues. One, the Board, composed of Presidential appointees, could be susceptible to pressure from an administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes. Neither case would be likely to occur given present legal and constitutional restraints. The Board members and employees are subject to strict fiduciary rules. They must invest the money and manage the funds solely for the benefit of participants. A breach of these responsibilities would make the fiduciaries civilly and criminally liable."

The Conference Report goes on to describe how the passive approach is designed to insulate the TSP from political pressure while allowing Plan participants to benefit from the long-term growth available in the broad markets.

Since the initial policy was established by the Congress in 1986, the Board, on its own initiative, has conducted two major investment policy reviews. Between 1993 and 1995, the Board reaffirmed the passive strategy, while asking the Congress to authorize additional passively managed index funds for investment.

Again in 2006, with the assistance of Ennis Knupp, our Chicago-based investment consultant, the Board undertook a second major review of TSP investment policy. This review again reaffirmed the passive management approach, which the Board continues to endorse and pursue.

Surveys of Federal employees by the Office of Personnel Management have shown that the TSP is very highly regarded. Our own surveys internally support the same findings. Investment legend John Bogle, the founder of Vanguard Mutual Funds, has characterized the TSP as "the best single savings vehicle in America today." The Board members and I are privileged to offer this valuable benefit to the men and women who serve our Nation, and we endorse continuation of this passive investment philosophy, which has served Plan participants very well over the past 21 years.

With regard to the second matter noted in your invitation, this is the second time in 16 months that I, as Executive Director, have been asked by a Member of Congress to publicly discuss why the Board does not specifically seek asset management services for minority or women-owned vendors. Last September, Congresswoman Maxine Waters invited me to address the same topic at the Congressional Black Caucus Foundation's Financial Services Issue Forum.

I accepted that invitation even though I knew that many vendors in attendance would not be pleased with my message. Nevertheless, I think it is important to speak openly to all members of the

financial services industry so there is a clear understanding of just what the Board is seeking when it goes to the marketplace for investment services.

First, for the reasons discussed above, the TSP offers only passive investments to participants. Consequently, we do not seek services from the very large segment of the financial services industry that offers various active management products. Our goal with regard to investments is to replicate the returns of the broad indices, as our statute requires.

Second, our law requires the Board to develop investment policies which provide for low administrative costs. I, and all of my predecessors, determine that the best way to achieve low administrative costs for the participants is to conduct a full and open competition for the asset management services we require. This process of open competition has resulted in the hallmark of the Plan's success, which is its very low administrative costs. In my view, this remain the gold standard for ensuring participants that this Plan is being administered exclusively for their benefit, as our guiding statute requires.

Some agencies may seek to further social or political goals when they spend taxpayer dollars to accomplish their missions. The Board, however, does not spend taxpayer dollars. Our administrative expenses are paid first from forfeitures and then from the investment earnings of all TSP participants. These expenses reduce the retirement savings of our participants and thus must be expended solely for their benefit. This highly focused approach governs all of our policy and business decisions, including the procurement of services.

Additionally, by statutory design, the financial services we seek are the plainest of plain vanilla. In writing and amending our statute, the Congress clearly intended that the TSP's funds are to be invested efficiently, keeping market impact to an absolute minimum.

I hope this testimony helps the subcommittee in its review, and I welcome any questions.

[The prepared statement of Mr. Long follows:]

STATEMENT OF GREGORY T. LONG
EXECUTIVE DIRECTOR
FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
BEFORE THE
HOUSE SUBCOMMITTEE ON THE FEDERAL WORKFORCE, POSTAL SERVICE,
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The TSP was created by Congress in the Federal Employees' Retirement System Act of 1986 following three years of study and hearings by the House and Senate committees of jurisdiction. The record of these proceedings shows that the committees received input from pension experts, academics, employee representatives, financial service industry representatives, and the Reagan Administration. Significant assistance was also provided by the Congressional Research Service and the General Accounting Office.

Various investment approaches were considered and, ultimately, the House and Senate decided on a passive investment policy for the TSP. Passive management in the TSP is achieved through the use of index funds. All of the stocks in an index are purchased; there is no "active" attempt to outperform the index through specific stock selection. The following passage from the Joint Explanatory Statement of the Committee of Conference explains how the conferees themselves described the crucial nature of this decision:

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The Conference Report goes on to specifically describe how the passive approach is designed to insulate the TSP from political pressure while allowing Plan participants to benefit from the long term growth available in the broad markets.

Since the initial policy was established by the Congress in 1986, the Board on its own initiative has conducted two major investment policy reviews. Between 1993 and

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With regard to the second matter noted in your letter of invitation, this is the second time in my sixteen months as Executive Director that I have been asked by a member of Congress to publicly discuss why the Board does not specifically seek asset management services from minority (or woman) owned vendors. Last September Congresswoman Maxine Waters invited me to address the same topic at the Congressional Black Caucus Foundation's Financial Services Issue Forum.

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Some Federal agencies may seek to further social or political goals (such as encouraging small, minority or woman owned business development) when they spend taxpayer dollars to accomplish their missions. The Board, however, does not spend taxpayer dollars. Our administrative expenses are paid first from forfeitures by those who leave service before vesting, and then from the investment earnings of all TSP participants. These expenses reduce the retirement savings of our participants, and thus must be expended solely for their benefit. This highly focused approach governs all of our policy and business decisions, including the procurement of services.

Additionally, by statutory design the financial services we seek are the plainest of plain vanilla. In writing and amending our statute, the Congress clearly intended that TSP funds are invested efficiently, keeping market impact to an absolute minimum.

I hope the testimony I am presenting today helps the Subcommittee in its review of the passive investment and procurement policies of the Thrift Savings Plan for Federal employees. I would be pleased to respond to any questions.

Mr. DAVIS OF ILLINOIS. Thank you very much.
We will now hear from Mr. Sobel.

STATEMENT OF MICHAEL SOBEL

Mr. SOBEL. Chairman Davis and members of the subcommittee, my name is Michael Sobel. I am here to testify on behalf of Barclays Global Investors and its role as the external manager for the Federal Thrift Savings Plan. As head of U.S. Equity Trading at BGI, I am responsible for equity and listed derivatives trading originating from the United States, of which responsibilities include assuring that the execution results are in line with BGI's best execution principles in managing our brokerage relationships.

I will begin by discussing our investment philosophy and our structure, both of which are focused on delivering highly reliable, low-cost investment results to institutional investors like TSP. By "institutional," I refer to defined benefit and defined contribution pension plans sponsored by corporations or public agencies, and to endowments, foundations, and other similar pools of capital. I will then say a few words about the services we provide to the TSP and elaborate on how we keep the costs associated with trading and investing as low as possible. I will conclude by discussing BGI's Emerging Broker Program, which has been in place since the early 1990's.

Barclays Global Investors was founded in 1971 as part of Wells Fargo Bank in San Francisco, CA. Today, we are owned by Barclays PLC, one of the world's leading financial services providers. We are headquarters in San Francisco with approximately 3,400 employees worldwide. Since our founding, BGI has remained true to a single global investment philosophy which we call Total Performance Management. BGI manages performance through the core disciplines of risk, return, and cost management. The success of our indexing methodology results from our focus on delivering superior investment results over time while minimizing trading and other implementation costs and rigorously controlling investment and operational risks.

We are honored to have served as an investment manager for the TSP since 1988, a relationship that we have retained in regular, highly competitive bidding process. BGI manages four of the investment options available for participants: the TSPC Fund, based on large-cap U.S. equities; the S Fund, based on mid and small-cap U.S. equities; the F Fund, based on Lehman Agg. Long-Term Bond Index; and the I Fund, based on the MSCI Europe Australia Far Index of non-U.S. equities. There is also a G Fund, which is managed by the U.S. Treasury and invests in U.S. Treasury securities. In August 2005, the TSP added a series of lifecycle or target horizon options that use the existing five options as the asset class building blocks with allocations in each lifecycle across the funds, these options being determined by a separate vendor selected by the TSP.

BGI provides investment management services to the TSP and no other services. This is also true of BGI's relationship with most of our other clients. In general, we provide only investment management services, which we consider to be our core expertise. The key to our success in asset management is our ability to minimize

implementation and trading costs. High costs and expenses of investing detract from performance and investment returns; lower costs increase the investment pool and put more money long-term into the pockets of investors.

Let me say a few words about how we do this. Each of our index funds is structured to match the performance of a specific index. These indices, such as the S&P 500 or MSCI EAFE, are designed by third-party index providers. However, these indexes are really paper portfolios and do not include any of the trading costs that real-world investors experience. Thus, to successfully achieve the performance target—that is, to track the index as closely as possible—BGI strives to minimize the real-world cost through a variety of highly efficient trading approaches.

Through the size and diversity of our client base, we are able to match or offset a significant portion of our clients' buy and sell orders internally, thereby reducing or eliminating market transaction costs. The internal matching of buy and sell orders is commonly referred to as crossing and is conducted and actively monitored by BGI pursuant to the terms and conditions of an exemption issued by the Department of Labor. All these transaction cost savings, which we estimate are in the hundreds of millions of dollars annually, are passed directly to the clients.

When we do trade in the external markets, we utilize carefully developed and managed trading strategies, and we access all possible sources of liquidity, including electronic marketplaces. Our trading activities are supported by dedicated trading research team whose sole job is to develop new trading strategies and techniques to minimize trading costs. Our prime objective is to achieve the highest degree of control over investment outcomes at the lowest possible cost. BGI has developed state-of-the-art systems which use automation to improve trading efficiencies and lower transaction costs, which are often found at major broker-dealers.

We execute our trades through broker-dealers who are prescreened for creditworthiness, as we believe all trading relationships incorporate some level of credit exposure to the executing broker. We rigorously monitor the prices at which our trades are executed relative to the number of market-related benchmarks to ensure that we are receiving best execution. We also use our scale to negotiate fairly low per share commission rates. BGI has not and has never used soft dollars in its trading activities on behalf of our funds. BGI does not accept direction from investment management clients as to its trading activities, including its selection of brokers with which it trades.

Over the course of a long-term investment, lower management fees and expenses can translate into considerable savings for investors. Indeed, index investing remains the most cost-effective and diversified way to gain exposure for most investors' portfolios.

Now I would like to discuss BGI's Emerging Broker Program. BGI is committed to promoting and utilizing new ideas in investment services in order that we may provide our clients with the best and widest range of execution services and alternatives that are consistent with our fiduciary responsibilities. In keeping with our fiduciary responsibilities, BGI has an explicit policy to select

the most credit-worthy counterparties that provide the best execution at the lowest possible cost.

At the same time, we recognize the diversity and complexity of today's business community and that recent trends in financial services have resulted in an increasing number of firms offering brokerage services that do not fit the traditional format of a full-service investment firm. These emerging brokers include minority business enterprises, women-owned business enterprises, disabled veterans enterprises, and other small firms offering alternatives to established and well-capitalized broker-dealers.

Within the contest of our overall trading requirements, BGI believes it is important to allow for the positive impact of innovative ideas and differentiated service from emerging brokers. The diversity of thinking and potential for creative problem-solving is often associated with the entrepreneurial culture of emerging brokers. This is an advantage that we have long recognized and wish to continue to provide for our clients. As a result, we have developed a separate program and approval requirements for emerging brokers.

Firms are selected on the basis of several criteria, including capital, business and regulatory track record, operational capabilities, trading talent, competitive costs, and reputation. For firms that pass the initial screening, BGI conducts due diligence, which often includes an onsite visit by BGI trading personnel. Once selected, our trading team works closely with the dealers to establish real-time connectivity, review order handling guidelines, and establish the best execution framework required to do business with BGI. We have found, in our experience, emerging brokers are most successful with us when they focus on working to match offsetting client order flow or in handling agency orders in small or mid-cap securities that have irregular trading patterns.

The nature of the investment strategies managed by BGI means the majority of our trading requirements will continue to be met by those firms that provide the necessary automation and high volume, low cost execution that is part of the advantage that we offer to our clients. However, also due to BGI's scale, we are often within the top 10 clients of an emerging broker in the program. We don't believe it is in either the broker's interest or in the interest of BGI and its clients to be the dominant customer of any brokerage firm, as it creates and poses dependency risks to both sides.

Because of our commitment to innovation, which we firmly believe originates in the diversity of ideas, we continue to refine our counterparty approval policies to ensure that they recognize the positive potential contribution of emerging brokers.

I thank you for the opportunity to speak with you today and I look forward to answering questions that you may have.

[The prepared statement of Mr. Sobel follows:]

Statement of Barclays Global Investors, N.A.

Michael Sobel, Managing Director and Head of US Equity Trading

Before the House Subcommittee on the Federal Workforce, Postal Service and the District of Columbia
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Thank you for inviting me to testify today about Barclays Global Investors ("BGI") and its role as the external asset manager for the Federal Thrift Savings Plan ("TSP"). We are honored to have served as an investment manager for the TSP since 1988, a relationship we have retained in regular, highly competitive bidding processes.

I will begin by discussing our investment philosophy and our structure, both of which are focused on delivering highly reliable, low cost investment results to institutional investors like the TSP. By "institutional", I refer to defined benefit and defined contribution pension plans sponsored by corporations or public agencies, and to endowments, foundations and other similar pools of capital. I will then say a few words about the services we provide to the TSP, and elaborate on how we keep the costs associated with trading and investing as low as possible. I will conclude by discussing BGI's "Emerging Broker Program", which has been in place since the early 1990s.

Barclays Global Investors, N.A. was founded in 1971 as part of Wells Fargo Bank in San Francisco, California. Today, we are owned by Barclays PLC, one of the world's leading financial services providers. We are headquartered in San Francisco with approximately 1800 employees in California and elsewhere in the US, and 1700 more employees worldwide serving the needs of our global clients. BGI created the first index strategy in 1971, just one of the many financial innovations we have pioneered.

Since our founding, BGI has remained true to a single global investment philosophy which we call *Total Performance Management*. BGI manages *performance* through the core disciplines of *risk, return* and *cost* management. The success of our indexing methodology results from our focus on delivering superior investment returns over time while minimizing trading and other implementation costs and rigorously controlling investment and operational risks. This approach helps us avoid investment 'fads' or a dependence on 'star managers or 'stock pickers'. It has been the foundation for the way we have managed money for over 30 years, and we believe it has served our clients very well.

As I noted earlier, since 1988 one of those clients has been the TSP. BGI manages four of the investment options available for participants—the TSP C fund (based on large-capitalization US equities), the S Fund (based on mid- and small- capitalization US equities), the F Fund (based on the Lehman Aggregate Long-term Bond index) and the I Fund (based on the MSCI Europe Australia Far East (EAFE) index of non-US equities. There is also the G Fund, which is managed by the US Treasury and invests in US Treasury securities. In August 2005, the TSP added a series of lifecycle or "target horizon" options that use the existing five options as the asset class 'building blocks' with allocations in each lifecycle fund across these options being determined by a separate external vendor selected by the TSP.

TSP participant assets are invested in bank collective funds (legally trusts), which are subject to Federal bank trust law enforced by the Office of the Comptroller of the Currency, the US regulator for national banks. TSP assets are commingled with other institutional investors in BGI's collective funds, many of which are subject to the Employee Retirement Income Security Act (ERISA). As such, BGI manages the TSP assets in compliance with both ERISA and the Federal Employees Retirement Security Act ("FERSA"), the enabling statute for the TSP.

BGI provides investment management services to the TSP and no other services. This is also true of BGI's relationship with most of our other clients. In general, we provide only investment management services, which we consider our core expertise. In fact, the key to our success in asset management has been our ability to minimize implementation and trading costs. High costs and expenses of investing detract from performance and investment returns; lower costs increase the investment pool and put more money long-term into the pockets of investors. Let me say a few words about how we do this.

Each of our index funds is structured to match the performance of a specific index. These indexes (such as the S&P 500 or the MSCI EAFE) are designed by third-party index providers. However, these indexes are really 'paper portfolios' and do not include any of the trading costs that real-world investors experience. Thus to successfully achieve the performance target—that is, to track the index as closely as possible—BGI strives to minimize the 'real world' costs through a variety of highly efficient trading approaches.

Through the size and diversity of our client base we are able to match or offset a significant percentage of our clients' buy and sell orders internally, thereby reducing or eliminating market transaction costs. The internal matching of buy and sell orders is commonly referred to as 'crossing', and is conducted and actively monitored by BGI pursuant to the terms and conditions of an exemption issued by the Department of Labor. All these transaction savings, which we estimate are in the hundreds of millions of dollars each year, are passed directly to our clients.

When we do trade in the external markets, we utilize carefully developed and managed trading strategies and we access all possible sources of liquidity, including electronic marketplaces. Our trading activities are supported by a dedicated trading research team, whose sole job is to develop new trading techniques and strategies to minimize trading costs. Our prime objective is to achieve the highest degree of control over

investment outcomes at the lowest possible cost. BGI has developed state-of-the-art systems which use automation to improve trading efficiencies and lower transaction costs.

We execute our trades through broker-dealers who have been pre-screened for credit-worthiness, as we believe all trading relationships incorporate some level of credit exposure to the executing broker. We also rigorously monitor the prices at which our trades are executed relative to a number of market-related benchmarks to ensure we are receiving best execution. We also use our scale to negotiate low per share commission rates. BGI does not and has never used "soft dollars" in its trading activities on behalf of its funds. In addition, BGI does not accept direction from its investment management clients as to its trading activities, including its selection of the brokers with which it trades.

BGI does not contract out any portion of its investment management activities for the TSP account, and generally does not use so-called "sub-advisors" in the investment strategies it offers its clients. Given the institutional nature of our client base, these clients will contract directly for investment strategies that BGI does not offer, thus avoiding the need to compensate both the advisor and sub-advisor for managing the assets in the chosen strategy.

Over the course of a long-term investment, lower management fees and expenses (including trading commissions) can translate into considerable savings for any investor. Indeed, index investing remains the most cost-efficient and diversified way to gain exposure for most investors' portfolios. Congress recognized this itself in FERSA, which provides that the public market options be invested in portfolios designed to replicate the performance of an index that is 'commonly recognized' as reflecting the performance of each asset class (i.e., the S&P 500 Index for large capitalizations US equities).

Now, I would like to discuss BGI's emerging broker program. BGI is committed to promoting and utilizing new ideas in investment services in order that we may provide our clients with the best and widest range of execution and service alternatives that are consistent with our fiduciary responsibilities. In keeping with our fiduciary responsibilities, BGI has an explicit policy to select the most credit-worthy counterparties that provide the best trade executions at the lowest possible cost. At the same time, BGI recognizes the diversity and complexity of today's business community, and that recent trends in financial services have resulted in an increasing number of firms offering brokerage services that do not fit the traditional format of a full-service investment firm. These emerging brokers include minority business enterprises, women business enterprises, disabled veteran enterprises and other small firms offering alternatives to established and well-capitalized broker/dealers.

Within the context of our overall trading requirements, BGI believes it is important to allow for the positive impact of innovative ideas and differentiated service from emerging brokers. The diversity of thinking and potential for creative problem solving is often associated with the entrepreneurial culture of emerging brokers. This is an advantage that we have long recognized and wish to continue to provide to our clients. As a result, we developed a separate program and approval requirements for emerging brokers.

Firms are selected on the basis of several criteria including capital, business and regulatory track record, operational capabilities, trading talent, competitive costs, and reputation. For firms that pass the initial screening, BGI conducts due diligence, which often includes an on-site visit by BGI personnel. Once selected, our trading team works closely with the dealers to establish real-time connectivity, review order handling guidelines and establish the best execution framework required to do business with BGI. We have found, in our experience, that emerging brokers are most successful with BGI when they focus on working to match offsetting client order flow

or in handling agency orders in small or mid-cap securities that have irregular trading patterns.

The nature of the investment strategies managed by BGI means that the majority of our trading requirements will continue to be met by those firms that can provide the necessary automation and high volume, low cost execution that is part of the advantage we offer our clients. However, also due to BGI's scale, we often are within the top ten clients of an emerging broker in the program. We don't believe it's in either the broker's interest, or in the interest of BGI and its clients to be the dominant customer of any brokerage firm, as it poses dependency risks to both sides.

Because of our commitment to innovation which we firmly believe originates in the diversity of ideas, we continue to refine our counterparty approval policies to ensure that they recognize the positive potential contribution of emerging brokers.

I thank you for the opportunity to speak with you today and I look forward to answering any questions you might have.

Mr. DAVIS OF ILLINOIS. Thank you, gentlemen, very much. We will proceed directly into a line of questioning.

Let me begin with you, Mr. Long. From time to time, we hear about possible political manipulation of TSP money and that one of the things that the Board is very conscious about and against is that kind of manipulation. Could you share with us some examples of what might be called political manipulation or attempts at political manipulation?

Mr. LONG. Sure. In the past, we have seen different groups that wanted to receive favorable treatment from the TSP. There was a group that represented commodities that thought we should have a commodities fund. There was another group that represented real estate investment trusts that thought we should have a real estate investment fund. There are groups that think they should receive favorable treatment, and there might be rational reasons behind those goals, but that is not what we do. We look out just for the best interest of participants' beneficiaries.

Mr. DAVIS OF ILLINOIS. You also mentioned in your testimony about surveys that you have done and, of course, surveys that the Office of Personnel Management [OPM] have done both indicate a high level of satisfaction on the part of employees, on the part of investors. What are some of the things that they indicated that perhaps they liked best about what was happening?

Mr. LONG. I think the most important statistic from the survey was the level of overall dissatisfaction. We had a level there of about 3 percent. So some participants are highly satisfied, some participants are kind of in the middle, but the number of people who are dissatisfied is in the single digits; and that says, on an overall basis, we are doing a darn good job. And when I say we, I mean not just the agency that I help run, but OPM and the Government as a whole.

The focus on the funds, we asked about specific funds. There is some desire for more funds, but then when you get down to the question of are you willing to pay more money for more funds, the answers change. What we also saw is a clear high usage and benefit of the Web site. In other words, people go to the Web site, they use it, and the people who use it often tend to make wiser investment decisions.

Mr. DAVIS OF ILLINOIS. Have you seen any place or would you say that there is any place in the law that would allow for consideration of social goals that could be used as part of the criteria for investing the funds?

Mr. LONG. The Conference Report specifically—and I am going from memory here, but the Conference Report specifically considered that and said that was not the intent of the TSP, that social goals should not be looked at as we determine what the investment options should be.

Mr. DAVIS OF ILLINOIS. In the 2006 bidding process, were there any minority companies represented or did any minority companies bid?

Mr. LONG. One moment.

[Pause.]

Mr. LONG. The answer is no, there were none. What I was just talking with Tom about is I can't discuss the names of the people who actually bid.

Mr. DAVIS OF ILLINOIS. Let me just go to you, Mr. Sobel, for a minute. Could you tell us a little bit more about the Emerging Broker Program?

Mr. SOBEL. Sure. Happy to. We started the program in the early 1990's. As our size and complexity grew, we were really interested in extending out the trading capabilities by looking to leverage the kind of creative and entrepreneurial capabilities of smaller firms, so we established this program. We are certainly also aware that many clients also had a keen interest in supporting it as well, which certainly didn't hurt the overall approach that we had already been kind of taking. And we have found, over the years, that by working with these brokers, that they learn from us and we learn from them, and we are able to really leverage their keen and intense focus on service, particularly for small and difficult names to trade in the marketplace.

Mr. DAVIS OF ILLINOIS. I am going to actually go now to Mr. Jordan, and I am going to ask Members if we would try and hold pretty close to the 5-minute rule, and we will do another round where we need to.

Mr. Jordan.

Mr. JORDAN. I thank the chairman. Whenever we have hearings on this type of issue, I am always reminded of the Will Rogers line who, I think, said, I am more concerned about the return of my money than the return on my money, which I think is important to keep in mind whenever we are talking about these kind of issues.

I will just do one question. Elaborate on this whole debate between active and passive investment strategies, and specifically tied into the fee structure typically associated with both, and maybe even look at bear markets versus bull markets and how that can impact. We can go with Mr. Long first and then Mr. Sobel.

Mr. LONG. We, by law, invest passively, so we do not employ an active approach. An active approach would be one in which you pay people, a manager, to make a determination between different stocks: do you buy Pepsi or Coke, and which one is the best over the long term. That is not a determination that we make in a passive style; we buy the whole marketplace.

Because you don't need to pay people to make that decision, these are typically very bright, well paid people, the expenses for passive management for index funds are lower, often substantially lower. It is not uncommon to have active management funds in excess of 100 basis points, sometimes in excess of 200 basis points. When you take a look at the TSP, our total cost, including all services, order costs for Web sites, statements, recordkeeping, investment management trading, all those expenses in aggregate net 1.5 basis points to participants. So it is an enormous difference, and that difference translates directly to the pocket of our participants and beneficiaries.

Mr. JORDAN. Would some argue that even with that fee structure in mind, bear market versus bull market, can you elaborate on that a little bit?

Mr. LONG. There are, and I have read them, papers out there that say active management generally does better in a bull market than a passive market, and in a bear market passive management tends to do better. You can find plenty of papers supporting both arguments. There are a lot of people that have their own self interests and research is created to support that self interest. The bottom line is, for the TSP, right now, we are required to do what we do, which is passive management. It translates to low fees and, over time, typically better returns than the average active manager fund is able to produce.

Mr. JORDAN. Mr. Sobel.

Mr. SOBEL. I regretfully concur with Mr. Long; the fees are unusually low for this particular investment style. We do, as a firm, believe that index investing, or passive investment strategies, are kind of key and core to any investment plan, so having a component of this as an option is incredibly important, just on the basis of the fee differential alone. So 100 or 150 basis points or 1.5 percent compared to 1/100th is a big hurdle to try to get over. So, from the cost perspective, the overall kind of approach to passive investing I think is fairly compelling.

Bull market versus bear market, application of index funds, the markets are incredibly complex and, depending on who you talk to, whether they believe in efficient market theory or not, it is very hard to beat the markets in either scenario, and market timing is a very difficult thing.

Mr. JORDAN. I thank the chairman.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Jordan.

Mr. Sarbanes, no questions?

Ms. Norton I am sure she does, but while she is on her way back, let me ask you, Mr. Sobel, is the Federal Government your largest client? Do you have a client larger than that?

Mr. SOBEL. I actually don't know the answer to that. I don't think the answer to that would be yes. So I think the answer to that is no, I do not believe that they are our single largest client.

Mr. DAVIS OF ILLINOIS. Oh, OK.

I see that Ms. Norton is back. Ms. Norton.

Ms. NORTON. Thank you very much, Mr. Chairman.

Could I ask, Mr. Long, has the TSP outperformed other publicly managed funds that are involved in active management, where the funds are invested with active managers?

Mr. LONG. We spend our time looking at the performance relative to the benchmark.

Ms. NORTON. Sorry?

Mr. LONG. I said we spend our time, in our analysis, looking at how we perform relative to the benchmark that we are required to perform to, and that we don't compare ourselves to other publicly managed funds. However, I can say that I am sure that other publicly managed funds that employ active strategies, some have probably outperformed us.

Ms. NORTON. Well, how do you perform with respect to the market, period?

Mr. LONG. We replicate the market.

Ms. NORTON. Explain.

Mr. LONG. Instead of buying some stocks, we buy all of them, and that is a strategy——

Ms. NORTON. So what happens to the market happens to you?

Mr. LONG. Whatever the market happens to do. And that is an incredibly——

Ms. NORTON. So risk-averse as you are, whatever happens to the market happens to you.

Mr. LONG. That is correct.

Ms. NORTON. So how are you faring now, Mr. Long?

Mr. LONG. Well, the market has had a tough month, tough 6 months, and it performs badly. Beating the market is a challenging thing to do. What you will find is some active managers are able to beat the market some of the time; an awful lot of them don't.

Ms. NORTON. I want to be clear, Mr. Long. I understand this is a Federal Government fund. I am asking these questions because I am trying to make sure this fund that was set up, with set up guiding principles a long time ago—how long has it been—investigates, looks at those principles and doesn't simply accept them, as I must say I hear you saying you don't even look at its comparison to other funds.

So I don't mind you concentrating on your work, but it seems to me, if anything, out of market intellectual curiosity, you want to know something about—I have in mind, Mr. Long, for example, there are State teachers' funds, there are a plethora of public funds in the market. They better not lose any more than we better not lose, because they are generally handling, sir, funds that are far more critical to those to whom they owe a fiduciary responsibility. They are handling entire retirement funds.

So I sense that we are taking care of everybody, and when I look at the plethora of public funds in the States that are infected in an active management, at least leads me to ask questions. Why are we so much more secure than they who have so much more at stake than we, because we certainly are not here talking about people's fundamental retirement.

Mr. LONG. The plans that you reference, the State plans, are, not all, but most, defined benefit plans, meaning that the participant, the end-user has a defined benefit that is irrespective of the way that the funds perform. The State has the obligation to pay the employee usually a fixed percentage——

Ms. NORTON. I am quite aware of that, Mr. Long.

Mr. LONG. OK.

Ms. NORTON. I don't see how that answers my question. You are saying to me that the State would have to pay in any case. Are you saying to me that the State has had to make up for losses? Is that what you are implying? I can understand a defined benefit plan and what it is supposed to do and what would happen if in fact there were losses. That doesn't answer my question. My question is that much more is at stake, there is much more to lose, and yet the investment is made. Why do they make the investment in that way?

Mr. LONG. I am not sure I understand why you are saying there is much more to lose.

Ms. NORTON. I am talking about often whole retirement funds. I am not talking about something like TSP, which does not involve people's entire retirement.

Mr. LONG. Well, the TSP is a core part of anybody who—is for employees, certainly, but it is not their only retirement source of income.

Ms. NORTON. Yes. So continue.

Mr. LONG. I am not sure what the question is, though.

Ms. NORTON. My question, Mr. Long, has to do with State funds that in fact often do involve people's entire retirement. And I want to know why the States do not feel that they are at substantial risk in having at least some of those funds in active management.

Mr. LONG. Well, they have experts. They sit down and they have experts that choose the funds. They have a pension management. The State of New York, they have a pension expert that sits down and decides what to invest those moneys in. Those are not made at the participant level, they are made at the trustee level.

Ms. NORTON. Obviously, Mr. Long.

Mr. Sobel, perhaps you can inform us of how—obviously these States, these pension funds, these union pension funds have had to calculate the consequences of a horrifically under-performing market. There is, I argue, even more of a reason to be risk-averse and, yet, they have in fact—I think you will hardly find a State that doesn't have substantial funds in active management, and I am simply trying to understand, since they have the same kind of fiduciary relationship to their employees as we do, except that they are usually holding funds that are far more important not their employees.

I am trying to find out what is the core difference in the decisionmakers. We are one here. There would have to be a State legislature who was there. Why do they take this risk and we don't take this risk even with a small, let us say, part of our funds? Do these States, do these funds feel they have a risk? How would you explain the difference in the approach, both of which require some very high level of risk-averse in deciding which approach to use?

Mr. SOBEL. Well, I think it is a great question. It is an extremely complicated area. It all has to do with what type of aversion to risk do you have. Certainly, as you pointed out, even passive strategies have a very substantial amount of market risk associated with them. Active strategies also bear that market risk; they have an additional layer of risk, which has to do with the stock selection.

Ms. NORTON. Have some of these active funds been able to beat the market in this market situation, which, as Mr. Long has had to say, has not been good for those who simply follow the market, whichever way it goes? Have some of the funds in active management been able to beat the market in this climate, in this economy?

Mr. SOBEL. Sure, some certainly have. But I think over the long run we have hundreds of thousands of clients from all over the world, and there are many examples of very large, sizable funds that make most, if not all, of their investment into passive strategies as a matter of policy, and we have seen others——

Ms. NORTON. Give me examples of those funds that make all their investments in passive.

Mr. SOBEL. I am not going to be at liberty to disclose any names of any funds.

Ms. NORTON. That must be a matter of public record, because they would want everybody to know that, especially those to whom they are responsible.

The point of this line of questioning is—which still has, I must say, not been responded to to my satisfaction, and I am sorry we don't have somebody from one of these State funds or State legislatures—is to try to get to the bottom of what it is we are afraid of so I know what it is, whether, in fact, we could hedge against it in some way or whether the best strategy is the strategy we have. A strategy, of course, we have, I must say, has been based on an economy that right under us is changing in fundamental ways that nobody understands. I have been having debates with friends about, well, you know, this mantra, you know, we are a robust economy, this is part of the cycle.

There is no cycle ever like this that we have seen. This is a perfect storm and it involves some uncontrollables that will always be beyond our control that have now become primary in this economy. And no one can imagine that for decades now they won't be. New actors in the economy, huge new hungry actors, and, of course, commodities like oil and food going ways that are completely adverse to the way in which this country was built. So someone who says, oh, it is a robust economy, we are having a downturn, seems to me is not doing the kind of analysis we need to do to try to understand this.

The analysts I most respect are those who are beginning to even question whether or not those who say the obvious, that, you know, the new actors, that is the reason for it. Those who have looked seriously say we don't even know the reason for it in a global economy.

So, Mr. Long, when you come and say all I do is look in my own navel, as much as I can understand that, we may wake up 1 day and find that we have not had fair warning, that there were other things we should be looking at. I don't know if one of those is piloting something in active management. I don't know. I don't know enough to know. My problem is I don't think you know enough to know. And I believe, in an economy that is really changing right from under you, that it is your obligation to know.

We did not know, at the time of the farm bill, for example, Mr. Chairman, I didn't know, I did not perceive, I hadn't read deeply enough to know that subsidizing ethanol was going to make us go completely off the cliff, because we had made that decision years ago. So here we are now eating gas and subsidizing it. So I must say I think the only thing to do is to bring self criticism and skepticism to everything we do, and especially to handling somebody else's money; and that is what you are doing now, you are handling somebody else's money, and I would hope you would be looking at how everybody else is handling it and what is happening to our economy.

I thank you, Mr. Chairman.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Let me just see if I can understand. Are there reasons we can define which suggest that teacher retirement funds, State funds

are instances where there is a greater reliance for ultimate retirement than what is on the TSP? Are we more judicious than those investors or are we more judicious than the handling of those pension contributions? Is there a defined rationale for that position?

Mr. LONG. Would you like me to respond?

Mr. DAVIS OF ILLINOIS. Yes.

Mr. LONG. For a teacher, for anybody who is entirely dependent on a single pension, then I think it is a fair statement, then you have somebody who is fully reliant on one pension plan, as opposed to the current three-tiered structure that exists under the Federal system. But does that change the basic fiduciary obligation to look out solely for the best interest of the beneficiaries? No. It doesn't change what we do.

Mr. DAVIS OF ILLINOIS. So I guess the most that we would end up being able to say is that we have a system and a process that is defined that is different than some others, and, yet, the outcomes are expected to be the ultimate protection in both instances. I am sure the people who invest teacher retirement funds want to make absolutely certain that, when Ms. Jones gets ready to retire, that everything is in place and everything is there.

Let me just ask another question. Given the lay of the land, given what we know, given the law, given what we have experienced, given what we have seen, do you see any wiggle room for movement toward accomplishment of the goal that I am certainly seeking, and that is the goal of finding a way that the level of diversity changes a bit from what it is in the direction of where we are trying to take it? Mr. Long.

Mr. LONG. Yes, and as the more companies grow—right now, BGI is our vendor. We will re-compete that again and again and again, and whoever is the best and whoever wins that competition will be the manager for at least some of the TSP. There is no reason to think that it has to be BGI in the future. And whether that is a woman-owned firm, minority-owned firm, as long as it is U.S.-based, they can compete.

Mr. DAVIS OF ILLINOIS. Mr. Sobel, let me just ask you does Barclays have an internal diversity or diversification program or goal or system? What is your position on diversification?

Mr. SOBEL. And this relates to our employee population that you are referring to?

Mr. DAVIS OF ILLINOIS. Yes. I mean the overall diversification. When I think of diversification, I really think of from top to bottom, I think of from side to crossways, I think of from up to down, and I think of what it is that we do.

Mr. SOBEL. I do know that we have a team focused on this, but I have to profess it is a bit outside of my core area of expertise.

Mr. DAVIS OF ILLINOIS. OK. Could you perhaps get an answer for us for that and get it back to us?

Mr. SOBEL. Yes, happy to.

Mr. DAVIS OF ILLINOIS. All right.

Thank you, gentlemen, very well. We appreciate your being here and we thank you so much for your testimony.

We will go to our second panel. Our second panel is going to consist of Mr. Edward Swan. Mr. Swan has over 32 years of institutional investment management and marketing experience covering

major domestic and international investment sectors, most recently as President of the Fiduciary Investment Solutions Group. Mr. Swan, we welcome you. Thank you very much.

Mr. Jarvis Hollingsworth is a partner in the public law section of the Houston, TX office of Bracewell and Giuliani. He also serves as a trustee of the Teacher Retirement System of the Texas Pension Fund, after serving as chairman from 2002 to 2007.

Gentlemen, we thank you very much. If you would stand and be sworn in.

[Witnesses sworn.]

Mr. DAVIS OF ILLINOIS. The record will show that the witnesses answered in the affirmative.

Gentlemen, we thank you so much for being with us, and we ask that you summarize your statements in 5 minutes. Your entire statement, of course, will be included in the record. Yellow light indicates that you have a minute left, if you would then sum up, and the red light indicates the time is over.

We will begin with you, Mr. Swan.

Mr. SWAN. Mr. Chair, with your permission, could I ask Mr. Hollingsworth to go before me? I think some of his comments will be very pertinent to the discussion that just occurred.

Mr. DAVIS OF ILLINOIS. Well, I have always been taught that age was before beauty anyway, so——

Mr. HOLLINGSWORTH. Does that imply he is older than me? Because I love that. [Laughter.]

Mr. DAVIS OF ILLINOIS. Mr. Hollingsworth, you may proceed. Thank you.

STATEMENTS OF JARVIS HOLLINGSWORTH, PARTNER, BRACEWELL AND GIULIANI, LLP; AND EDWARD SWAN, JR., PRESIDENT, FIDUCIARY INVESTMENT SOLUTIONS GROUP

STATEMENT OF JARVIS HOLLINGSWORTH

Mr. HOLLINGSWORTH. Thank you, Mr. Chairman, members of the subcommittee. It is an honor to be here today to discuss these issues with you. My name is Jarvis Hollingsworth. I am a lawyer and a partner with the law firm of Bracewell and Giuliani in Houston. I was most recently the chairman of the Board of the Teacher Retirement System. It was a privilege to serve the active and retired teachers of Texas for over 6 years as a fiduciary and steward of their retirement dollars.

The System, typically referred to as Texas Teachers, about $112 billion as of market today, serves over 1.2 million retired and active teachers. It is the sixth largest public pension plan in the country. The plan pays out over $5.5 billion a year in benefits. It is a defined benefit plan and therefore is the sole retirement of the teachers and the retirees.

I will address three issues here today. First, recent changes in the investment allocation at Texas Teachers. I will then talk about the use of external managers and moving Texas Teachers from a passively managed strategy to some active management. Third, I will give the subcommittee some background on efforts under my leadership at Texas Teachers to increase minority participation at the fund, as you seek to do here possibly at TSP.

During fiscal year 2006, our Board of Trustees instituted a very thorough review of the investment program. One objective was to increase the return to the fund without an increase in risk. A second objective was to review the fund's asset allocation in order to lessen the fund's exposure to dramatic swings in the stock market and to achieve a more efficient and more balanced asset allocation. We determined that these objectives would help the fund, first, meet our future pension obligations; second, be more cost-effective; and, third, manage our risk in a very proactive manner.

In recent past, the Texas Teachers portfolio was concentrated in large domestic equities. Hence, in good and bad economic times, a majority of our fund's returns had historically been driven by the performance of these publicly traded instruments. Prior to the board's reallocation of the assets in 2006, which I will get to in just a moment, the proportions of our total investment strategies were 65 percent equities, 26.8 percent fixed income, 4.3 percent that was spread across the various alternative assets, private equity, real estate, and hedge funds, 3 percent in cash instruments. So over 90 percent of the fund at that time was essentially invested in an enhanced index or passive management approach.

One of the things that led us to the study was, when I first came on the board in 2002, I was there to experience the tech bust in the stock market. Our plan was at $95 billion when I came on the board, and within 18 months the plan was down to $65 billion. So there are examples where you do well with the stock market and, of course, it is both good and bad times.

After our study, we created three new major asset categories for the fund: one, global equities, which constituted 60 percent of the portfolio, that includes all public and private equity; 20 percent in an allocation called stable value, which included all fixed income credit, U.S. treasuries, hedge funds and cash; the remaining 20 percent were in our real return asset category, which included real estate, real assets, commodities, and global inflation-linked bonds.

This reallocation that we did in 2006 moved the fund away from the traditional large U.S. public pension model of being highly weighted in publicly traded stocks and bonds, and allowed the fund to guard against the downturns in certain markets and better capitalize on the strong returns of the less traditional asset classes. In addition to being a better balanced portfolio, it offered greater diversification, the opportunity for more robust returns, and took advantage of the fund's competitive advantages: a long investment time horizon of 10 years and very limited short-term liquidity requirements. This asset reallocation also decreased the fund's downside risk, lowered the volatility in the portfolio, and lowered the correlation among the portfolio's asset classes.

I will talk a bit about active and passive and external managers. Texas Teachers has a very long tradition of managing the assets internally. As of 2006, over 90 percent of our assets were managed internally by Texas Teachers investment professionals. We are very proud of that fact and, for the most part, it generated returns that were at or above those of external managers.

While this internal management resulted in an effective, low-cost system that produced consistent returns over time, staff, in conjunction with our external consultants, determined, after this

study, that a combination of both internal and external management would allow for a more effective portfolio design that diversifies risk across managers and investment strategies.

If I could, I would just like to take a second to talk about the emerging manager program. I think the case has been made, and you will hear a lot today, Members, that young talent of small and emerging managers have outperformed their large counterparts in both up and down markets. They also diversify a large portfolio as they give these plans access to sectors, strategies, and geographies that are not meaningfully available to large funds.

Texas Teachers launched our first small and emerging manager program in 2004 primarily to diversify our private equity portfolio. At that time, our portfolio was predominantly only large buyout plans.

Diversity of investment professionals was also important to our board, and we felt it very complimentary to the risk return goals at Texas Teachers. Due to their recent emergence in the investment management area, minority and women-owned firms are more likely to be in the small and emerging manager space and, therefore, diversifying a portfolio to include such strategies presents additional opportunities for pension plans to develop and increase the number of meaningful relationships that it develops with women and minority-owned funds.

Currently, small and minority manager programs have been implemented in Texas in our private equity and our hedge fund portfolio, and we are currently evaluating adding small and emerging plans to a fund of funds in our global equities and real estate portfolios. The board's goal is to get that allocation up to $1.5 billion; it is currently at about $800 million.

And I am summarizing, Mr. Chairman. I apologize.

In further efforts to increase the fund's relationships with minority and women-owned funds, in 2006, Texas Teachers launched a minority and women-owned brokerage program. It is a 6-month pilot program in which these firms are allowed to execute trades, after which their execution is evaluated for a determination of whether they should be included on the System's approved list of brokers. Texas Teachers has been very pleased with the results of this program.

Finally, we felt that minority and women-owned funds are uniquely positioned to find and take advantage of attractive demographics and opportunities for targeting high-growth ethnic and economic sectors consistent with recent demographic changes, and that these are very complimentary to the risk and return goals of a plan fiduciary.

As pension plan obligations continue to increase and the global investment marketplace continues to rapidly change, plan fiduciaries must search for ways to invest more efficiently and more effectively, and to boost returns while reducing long-term risk. We are confident that the investment changes made at Texas Teachers will serve the interest of the members, the retirees, and the pension fund, and are consistent with the board's fiduciary duty.

I hope this review of recent Texas Teachers activities has been of assistance to this subcommittee as it carries out its vital oversight of the Federal TSP. Please feel free to contact me if any mem-

bers of the subcommittee would like access to any of the information that was assembled in our board's reallocation of the fund's assets or the board's decisions to use external managers or to implement the fund's small and emerging manager programs. Thank you.

[The prepared statement of Mr. Hollingsworth follows:]

Statement of Jarvis V. Hollingsworth

Partner, Bracewell & Giuliani LLP – Houston, TX

Before the Subcommittee on Federal Work Force, Postal Service

and the District of Columbia

Committee on Oversight and Government Reform

U.S. House of Representatives

Hearing on Investing in the Future: Minority Opportunities and the Thrift Savings Plan

July 10, 2008

Chairman Davis, Ranking Member Marchant, and Members of the Subcommittee, thank you for this opportunity to testify on this matter of great importance to millions of federal workers. My name is Jarvis Hollingsworth and I am a partner in the Houston office of the international law firm of Bracewell & Giuliani. While I am a former Board Chair of the Teacher Retirement System of Texas, the views I am expressing today are my own and do not reflect either the position of the System or my firm.

The Teacher Retirement System of Texas ("TRS") is a state agency that manages a $112 billion-plus pension trust fund and administers an array of benefits, including healthcare programs, for over 1.2 million retirees and active teachers. TRS is the sixth largest public pension plan in the United States. The System pays out over $5.5 billion in annual benefit payments. As trustees of the system, the board is actively involved in hiring investment advisors, determining asset allocation and formulating investment-benefit policies for the fund which invests in domestic and international securities, private equity, real estate and hedge funds. As fiduciaries, the board, with advice from staff and external consultants, sets policy and asset allocation that it collectively determines is in the best interest of the constituents. I also served on the board of directors of the Texas Growth fund, a private equity fund focused on investing in Texas-based companies.

Pursuant to the June 26, 2008 letter from Subcommittee Chairman Davis, my discussion today will address three main issues:

1. Recent changes in investment asset allocation at TRS;

2. The use of external managers moving TRS from a passively-managed strategy to some active management; and

3. Exploring ways to increase minority participation in the management of the TSP.

ASSET ALLOCATION

During fiscal year 2006, the TRS board instituted a review of the investment program. The objective was to increase the returns without an increase in risk, and to enhance the competitiveness of the fund. The board, in cooperation with the staff and external consultants, conducted a comprehensive review of TRS policies and practices. The review centered on four key initiatives:

1. Establishing a more efficient and holistic asset allocation;
2. Accessing external managers where appropriate;
3. Using derivative instruments to manage risk and increase efficiency; and
4. Establishing risk management principals and practices.

The board determined that these initiatives would help the fund meet its future pension obligations, be more cost-effective and manage risk in a proactive manner.

In recent years, the portfolio was concentrated in large domestic equities. Hence, a majority of the fund's returns were traditionally driven by the performance of these publicly-traded instruments. In August 31, 2006, the proportions of TRS' total investment assets were 65% equities, 26.8% fixed income, 4.3% spread across the various alternative assets (private equity, real estate and hedge funds) and 3.9% in cash instruments. Over 90% of the fund was essentially invested in an enhanced index or passive management approach.

In order to achieve a more efficient allocation policy and lessen the fund's exposure to dramatic swings in the stock market, TRS conducted a comprehensive asset allocation study that included both public and private markets implemented through both traditional and alternative investment markets. This study resulted in the definition of three major asset categories: global equities (60% of the portfolio), which includes all public and private equity; stable value (20% of the portfolio), which includes all fixed income credit U.S. treasuries, hedge funds and cash; and real return (20% of the portfolio), which includes real estate, real assets, commodities and global inflation-linked bonds. This reallocation moved the fund away from the traditional model of being highly weighted in publicly traded stocks and bonds and allowed the fund to guard against the downturns in certain markets and better capitalize on the strong returns of less traditional asset classes. In addition to being a better balanced portfolio, it offered greater diversification, the opportunity for more robust returns and took advantage of the fund's competitive advantages – long investment time horizon (ten years) and very limited short-term liquidity requirements. This asset reallocation also decreased the fund's downside risk, lowered the volatility in the portfolio and lowered the correlation among the portfolio's asset classes.

ACTIVE v. PASSIVE MANAGEMENT AND EXTERNAL MANAGERS

TRS has a long-standing tradition of managing the assets of the trust internally in a cost-effective manner. As indicated earlier, the vast majority of the assets as of October, 2006, were internally managed by TRS investment professionals. This strategy resembled what many described as an enhanced index or a passive management approach, and was not unlike the structure of many large pension plans. As a matter of fact, 70% of pension plan assets are managed by plan investment professionals. While this resulted in an effective, low-cost implementation of policy that produced consistent returns over time by a highly professional and competent group of TRS investment professionals, staff, in conjunction with the board and its advisors, determined that a combination of both internal and external management would allow for a more effective portfolio design that diversifies risk across managers and investment strategies.

As reported to the board by TRS investment staff, external managers can be beneficial to the performance of the fund in many ways. First, external managers give the fund access to unique strategies not available from in-house resources. External managers often specialize in specific strategies that have been refined over time after incurring significant development and implementation costs. While there are clear benefits to having a variety of strategies available for investing fund assets, in many cases it may not be economically feasible to internally identify and develop additional strategies with above-average returns or desirable diversification characteristics. This is especially true for investment in areas such as emerging markets, private issues, or non-financial assets. Engaging external managers that already have these capabilities can be an effective way to take advantage of the attractive returns and diversification effects of these unique strategies without incurring prohibitive development costs or refining new strategies through trial and error.

External managers can also assist in improved risk management for higher risk or high yield strategies. These strategies require more sophisticated risk management efforts to insure that they reflect an appropriate level of risk. External managers that have successfully implemented higher risk and/or high yield strategies to enhance earnings have already developed the necessary infrastructure to measure, monitor, and manage the unique risks associated with these strategies. There is strong support throughout the investment industry that the use of external managers is an appropriate strategy when used in conjunction with suitable controls and risk management resources. They can be used to improve investment returns, manage existing risk exposures, and achieve significant efficiencies in the administration of pension assets. A significant number of large pension funds currently use external managers to assist in achieving their investment goals. In the 2007 legislative session, the Texas legislature authorized TRS to use external managers to manage up to 30% of the fund's assets. TRS is currently undergoing a process to structure a due diligence program to review and select its external managers.

External managers, however, are not without their costs. There are obviously management and performance fees associated with the engagement of external managers and this factor weighed heavily in the decision by the TRS board to engage external managers. As a bit of background, prior to the implementation of this investment process in October 2006, TRS had one of the lowest per-member costs among U.S. public pension plans. However, after much consultation

with TRS' internal staff and external consultants, the board concluded that given the opportunity to improve investment returns gained by the engagement of external managers, combined with the diversification that would result from the added expertise in specific strategies not available from the TRS staff, and the improved risk management, the increased costs were worth the engagement of external managers in certain asset classes. As discussed earlier, the external manager program has not yet been implemented as TRS is currently undergoing a process to structure the due diligence program to review and select its external managers.

All in all, a more diverse combination of market exposures gained through a balanced asset allocation, active management strategies, where appropriate, combined with the inclusion of highly skilled external managers selected through a prudent process, can improve the overall results of a fund by boosting returns and diversifying risks.

SMALL AND EMERGING MANGERS AND MINORITY AND WOMAN-OWNED FUND PARTICIPATION

As fiduciaries of public funds, trustees have a duty to seek superior, risk-adjusted returns for their annuitants, and the case has been made that young, talented small and emerging managers have out performed their large counterparts in both up and down markets. While these young managers generally have shorter track records and less experience, they can have a very strong competitive advantage due to the absence of a legacy portfolio and the ability to devote more time and resources to the investment process. Also, in the area of private equity, for example, the continued upward trend in fund and deal size creates opportunities for outsized returns for these small and emerging players who can take advantage of a relatively lower level of competition and more favorable valuations. They can also diversify a portfolio as they typically target sectors, strategies and geographies, and allow limited partners the opportunity to gain meaningful allocations in their fund.

TRS launched a small and emerging manager program in 2004 as part of a broader effort to diversity the private equity investment portfolio. One of the primary objectives of the program was to indentify less-established private equity funds viewed to possess the requisite underwriting skill and discipline to provide top-quartile investment returns. Prior to establishing the program, TRS invested primarily in the nation's largest private equity funds.

Diversity of investment professionals is also important and is very complimentary to the risk/return goals at TRS. Minority and woman-owned managers are more likely to be in the small and emerging manager space and give pension plans a means to develop meaningful relationships with such businesses. TRS is committed to increasing the number and size of its relationships with minority and woman-owned firms having the qualifications to assist in fulfilling the TRS mission, in accordance with TRS' fiduciary responsibilities to plan participants. In addition, the reallocation of the plan's assets in October 2006 also provides additional opportunities for TRS to increase the number of relationships it has with minority and woman-owned managers. Currently, small and emerging manager programs have been implemented in the TRS private equity and hedge fund programs through the use of fund of funds, and TRS is currently evaluating fund of fund managers for the implementation of small and emerging manager programs in the global equities and real estate portfolios.

In addition, in 2006 TRS launched a minority and woman-owned brokerage program to increase the fund's relationships with these businesses. It is a six month pilot program in which these firms are allowed to execute trades for a six month period, after which their execution and/or research is evaluated for inclusion on the system's approved list of brokers. TRS has been very pleased with the results of this program.

In light of the projected demographic changes in the U.S. and abroad, investing in funds targeting under-served markets offer attractive opportunities to pension plans to potentially enhance returns that opportunistically target high-growth ethnic and economic sectors. This risk/reward appeal of minority and woman-owned firms to institutional investors mirrors the attractive demographics among minority groups who are projected to account for a vast majority of the overall U.S. population growth in the very near future. In addition, minority purchasing power and businesses owned by minorities continue to grow by increments vastly exceeding the U.S. average. Moreover, according to the U.S. Census Bureau, women currently account for 51% of the total U.S. population and have significant influence on consumer behavior. As such, businesses that are successfully catering to the female market are also well positioned for growth and profitability. Minority and woman-owned funds are uniquely positioned to find and take advantage of these attractive opportunities for targeting high-growth ethnic and economic sectors, and are, therefore, very complimentary to the risk/return goals of plan fiduciaries.

As pension obligations continue to increase and the global investment marketplace continues to rapidly change, plan fiduciaries must search for ways to invest more efficiently and effectively and to boost investment returns while reducing long-term risks. We are confident that the investment changes made at TRS will best serve the interests of the members, the retirees and the pension fund.

I hope this review of recent TRS activities has been of assistance to the Subcommittee as it carries out its vital oversight of the federal TSP. Thank you.

Mr. DAVIS OF ILLINOIS. Thank you very much.
We will go to Mr. Swan.

STATEMENT OF EDWARD SWAN, JR.

Mr. SWAN. Thank you, Mr. Chair and members of the committee, for inviting me. I do want to make one correction for the record. I am the former president of FSI Group. I happily retired last July, after almost 35 years in the investment business. I have worked for large firms, small firms, and across a variety of investment strategies, and that gives me a fairly distinct perspective. I have also served as a graduate business school professor.

What I hope today, the committee certainly has a grasp of active and passive, the definition of those two terms, but I am going to make a few comments about the implications of active versus passive management.

The whole goal, obviously, of active management is to out-perform a series of a given benchmark. The goal of passive is to provide performance at very low fees in line with a given benchmark. I would suggest, as the committee thinks about the TSP, that the real goal, long-term, on behalf of the participants of the Plan is how do you maximize their accumulations. How do they wind up, at the point that they retire, with the maximum amount of money against which to retire?

I will make four points. The first is that the data shows the likelihood of picking an active manager that will out-perform the benchmark, and picking a manager on a random basis, increases to the extent that the market that you are looking at is inefficient.

What do I mean by an inefficient market? If you are buying treasury bonds, everybody knows just about everything there is to know about each treasury bond, so no one has an information advantage. That is an efficient market.

An inefficient market might be small cap stocks, where I might know about a company that my competitor doesn't know about, or I might be able to do better research about that company; hence, I have an information advantage. I can choose to buy that stock or choose not to buy that stock based on something that will give me an edge.

So to the extent that markets are inefficient, active management really, probably ought to play a larger role.

The second point is that—and remember, those data are based on random selections of managers. So the second point is that a smart staff, employing good consultants, ought to be able to select managers more effectively than on a random basis.

The third point that I would make is that purveyors of passive funds argue that the fees are low, and, indeed, that is quite true. But the TSP is a huge fund; it has massive buying power. And having been at firms that have done both passive and active management, I can tell you that the TSP has the bargaining power to squeeze active fees down in a way that it hurts active managers. The fee spread, given TSP's active management—the fee spread, meaning the difference between active management fees and passive management fees—would be narrowed considerably by TSP's bargaining leverage.

The fourth point that I would make is that the availability of software and technology now enables small firms to compete much more effectively than they could even 5 years ago, so that it may be a mistake in the interest of being risk-averse to overlook small firms just so you could have a behemoth that somehow may have some advantages, or may not.

I hope my comments have been helpful. I would welcome any questions that you have. And I would leave you with one other thought as you deliberate. We talk about risk aversion and we talk about risk versus a benchmark. Bear in mind that there is nothing magic about the benchmarks. They are not sacrosanct. They, in fact, are passively held portfolios designed by a committee. The S&P 500, I think it is 10 people sit around and say these are the stocks that are going to be in the S&P 500. They are not sacrosanct.

So I hope my comments have been helpful. I would welcome any further questions. Thank you, Mr. Chair and committee members.

[The prepared statement of Mr. Swan follows:]

TESTIMONY OF EDWARD M. SWAN, JR., CFA
FORMER PRESIDENT
FIS GROUP

Before the

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA
HON. DANNY K DAVIS, CHAIRMAN

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U. S. HOUSE OF REPRESENTATIVES

"INVESTING IN THE FUTURE: MINORITY OPPORTUNITIES AND THE FEDERAL RETIREMENT THRIFT SAVINGS PLAN (TSP)"

JULY 10, 2008

BACKGROUND

I am Edward M. Swan, Jr., CFA. I attended Tufts University and received my MBA from the Wharton School. I recently retired from daily participation in the financial services industry after over 33 years as an analyst, portfolio manager, marketing professional and executive. I have worked for very large firms, such as Prudential, UBS and MFS. My experience also included playing an important role at several smaller firms, such as WR Lazard and FIS Group. I also was a graduate business school faculty member developing and teaching advanced investment courses. Currently, I serve on the investment committees for several universities and a foundation. My career has given me perspective on a wide range of investment strategies and some great firms.

I attended as a potential bidder what I believe to have been the first (or at least a very early) bidders conference for the Thrift Savings Plan ('TSP') in the mid to late 1980's. I remember being struck at that time how the RFP seemed to have been written with such high barriers to qualification that only a very few investment management firms could participate. The most critical barrier about which I speak involves assets under management ('AUM'). Literally, the AUM requirement was so high that I remember thinking there could not be more than 5 firms in the country 'qualified' to bid. While time distorts the memory a bit, I don't believe the very small number of 'qualified' bidders is exaggerated. Please remember that 'qualified' to bid is quite different from capable of rendering the requested service. Today we are talking about how to enhance an important retirement benefit program by opening it up to more firms capable of rendering a broad range of investment related services.

THE KEY POINTS IN MY TESTIMONY ARE -

1. Passive (normally referring to indexing during my testimony) management has an important, but limited role in managing portfolios.
2. Active management can add value.
3. DC plan participants deserve to have a broad range of investment choices. This point is important to make, but will be covered more fully by other presenters.

ACKNOWLEDGEMENTS

I want to thank Equitas Capital Advisors for their valuable assistance in research and providing the charts and tables contained in the Attachments.

IMPORTANT DEFINITIONS

The first set of important definitions has to do with different investment approaches.

- Active management is the effort to provide investment returns greater than a specified benchmark or index, such as the S&P 500 or the Russell 3000 ('R3000'). This is the classic beat the benchmark approach. It almost always involves an effort to pick the securities most likely, in aggregate, to provide performance over a reasonable time period ahead of the benchmark of index. These portfolio construction efforts can be
  - top down i.e. where you try to determine the direction of the economy and its implication for specific industries and or companies or
  - bottom up i.e. where you look for various company financial characteristics.
  - Most active managers use various combinations of both approaches.
- Passive management is a second major approach. The objective of passive management is to produce returns nearly identical to a specified benchmark or index, generally at a low fee.

The second set of important definitions has to do with the characteristics of the retirement program itself.

- Defined benefit ('DB') plans are the classic pension fund where the plan sponsor 'guarantees' some benefit based on years of participation and salary levels.

- Defined contribution ('DC') plans are based on the amount the employee contributes, often with some sort of employer match. A 401(k) would be an example of a DC program. The most common format is that the employee has a range of investment options representing various expected risk/return tradeoffs and other preferences. We will come back these choices the employee should be allowed to make because that is a critical point.

GENERAL COMMENTS

What are the arguments for and against active and passive management? In summary, the proponents of passive management claim that over time most active managers won't beat the benchmark anyway, so why bother paying higher fees and enduring the risk. Active managers make two key points. First, many if not always a majority of managers do beat their benchmarks. Second, the compounded effect on the growth in a portfolio's value from beating the benchmark over time is so great that it is worth the effort.

What do the data say about active versus passive management? The most important conclusion to draw is that many, if not always a majority, of active managers do perform better than their benchmark. How much better is a function of several factors –

1. manager skill
2. level of market efficiency – the most efficient market would be US Treasury issues (where almost all information is known by almost all participants) through inefficient markets, such as non-US developing equity markets (where the information is much more limited and less widely distributed). Managers operating in less efficient markets have a greater opportunity to outperform their benchmark(s).
3. market direction – it is generally easier to outperform in falling markets because of cash holdings

We looked at five basic sectors, four of which are in the TSP. They were domestic fixed income (Attachment 1), domestic large cap core equity (Attachment 2), domestic small cap core equity (Attachment 3), non-US developed equity markets (Attachment 4) and non-US developing equity markets (Attachment 5). What were the important conclusions?

1. Active managers in certain asset classes over time seem to have a higher likelihood of performing better than their benchmark (i.e. providing 'excess return'). Domestic fixed income seems to be most difficult to add significant value above the benchmark. Large cap core equity tends to add more excess return, but still less than the non-US developed market managers and small cap

core equity managers. This phenomenon exists largely because of the different levels of information available about securities in different markets (i.e. 'market efficiency'). For example, almost every institutional investor has the same information available to them about US Treasury issues or IBM as every other institutional investor. The differences in portfolio performance are largely determined by the manager's skill. Conversely, each small cap core company may be covered by only a few analysts. Information about these companies, beyond annual reports, other regulatory filings and online data sources, may be limited. Therefore, investment managers have an opportunity to discover 'hidden gems' in this sector.

2. You will also note that over time the difference between the best performing managers (shown as the 5th percentile at the top of each column on Attachments 1 through 5) and the worst performing manager (shown as the 95th percentile at the bottom of each column) tends to narrow over time. This phenomena is called 'mean reversion' and occurs because over time managers make some good decisions and some not so good decisions. Skilled managers, those providing excess return over time, simply tend to make more good decisions than bad decisions. Conversely, managers failing to provide 'excess return' tend to make more poor decisions than good ones.

Manager fee levels are another important consideration. As an example, if an active investment firm provides performance 0.90% ('90 basis points') above their benchmark, yet charges the client 1.00% ('100 basis points') and an index investment firm charges 0.10% ('10 basis points') to achieve benchmark level performance then little has been accomplished in terms of wealth accumulation for the client. Obviously, this construct ignores issue of relative risk for the sake of simplicity. The lowest fees tend to be charged in -

- The most efficient market sectors. In our case that would be for domestic fixed income.

- The lowest risk strategies. In our case that would be for indexing rather than active management.

The critical decision factor is whether the expected return from an active investment strategy, net of the fee, will be greater than the expected return from an index strategy, net of fee. Again, relative risk has been ignored for simplicity's sake. The TSP has very large plan assets and hence has the bargaining power to demand extraordinarily low fees. As an example, if we were to assume that the TSP were to select active managers performing only at the median manager level for the past 20 years, then there would have been a significant enough spread between the benchmark performance and the manager performance to more than accommodate active management fees. REMEMBER, this example is based on the assumption that the TSP staff and their consultants could do no better selecting the median manager. One would certainly hope that well paid investment consulting professionals could do better than select median performers, since median

performance could be achieved at no cost by random selection of managers within each sector. The following data are drawn from Attachments 1 through 5.

Sector	Median Mgr	Benchmark	Spread
Core Bond	7.33%	7.48%	(0.15%)
Large Cap Equity	11.45%	10.92%	0.53%
Small Cap Equity	12.82%	9.79%	3.03%
Int'l Equity (Dev.)	9.56%	6.54%	3.02%
Int'l Equity (Emerg.)	17.64%	14.53%	3.11%

As you can see from the preceding data, all of the equity sectors could have sustained active management. Certainly, small cap and international equity have very significant spreads. Again, these spreads were generated by a process equivalent to random selection of managers. One would hope that staff and consultants could provide better than random results.

It is reasonable to question whether small differences in performance will make a meaningful difference in wealth accumulation for the average TSP participant. Despite the importance of asset allocation, the following example shows that over time performance even slightly exceeding the benchmark is a powerful tool for building retirement assets. The data shown below provides an indication of the final asset accumulation for a participant depositing $10,000 at the end of each year for 20 years, assuming no withdrawals.

Avg. Annual Return	Total Accumulation
5%	$255,406
6%	$268,704
7%	$282,797

8%	$297,781

While on the surface the differences in accumulation may not seem major, they are of considerable importance if these accumulations represent a significant percent of the assets upon which a retiree must live. If active management can help increase returns above those provided by indexing, then that is of value.

Given that our primary focus is on improving the overall retirement program, what are the most critical factors impacting asset growth? The most important factor is getting plan participants to make the maximum possible deposit into the plan each year. The item having the second most impact is the allocation of assets between the various investment sectors. The old adage of a 'rising tide raising all ships' is true for asset allocation decisions. It is generally agreed that 90% to 95% of a portfolio's total return will come from asset allocation. If the stock market is going up, it is important to be in the market, since all managers will benefit, albeit some more than others.

Another way to enhance the Plan is to make additional investment options available that are expected to increase diversification and/or improve performance. Attachment 6 provides a correlation matrix listing asset classes expected to perform well over time. The point of the matrix is that while all of the asset classes in the attachment are expected to add value over time not all will perform well at the same time. This is the basic principle underlying the rationale for diversification. Thus, when domestic all cap equities (R3000) are performing well, approximately 63% of the time non-US developed equity markets will not be performing as well. Conversely, if non-US developed equity markets are performing well then 63% of the time domestic all cap equities sell. These asynchronous ups and downs reduce risk and smooth performance over time.

Attachments 7 through 9 show the risk return trade-offs for each of the asset classes for 7, 10 and 20 year periods. While there are only three years of private equity/venture capital data from the proxy benchmark, it does seem clear the addition of these two sectors has the distinct prospect of improving returns and reducing risk.

Several of these sectors – venture capital/ private equity and real estate – are very powerful producers of future return and have low correlations to more traditional asset classes. Hence, they can be important additions to a portfolio, yet they do not lend themselves to passive/index management. These types of investments have traditionally been used by DB plans and high net worth programs. While this is not the forum for discussion how they might be included as limited participation options, I suggest such exploration could be of immense benefit to Plan participants.

Over the past 20 years there have been two important changes that allow very large plan sponsors to successfully use the services of smaller financial service vendors –

1. The cost of powerful technology used for investment management, brokerage and other financial services has been lowered to the point that firm size should not be a limiting factor as to whether services can be effectively rendered

2. The very successful advent of manager of manager programs allow smaller specialized investment management firms to be combined to compete very effectively with the largest firms in our business

At this point smaller, minority minority and/or women owned firms should have the opportunity to offer their services to the participants of the Thrift Savings Plan. Conversely, the participants of the TSP should have the opportunity to select from a broader range of investment management providers. Others among my associates testifying today will address this topic in greater depth.

SUMMARY

There are two central questions.

The first is whether there is a reasonable possibility of selecting active managers with the capacity to outperform the benchmark over reasonable time periods. The answer yes it is very possible to improve overall plan performance through the addition of carefully selected active managers. The TPA either currently has or should have the resources to assist it with the manager selection process. The industry is served by a number of consultants with the skill to pick managers capable of adding value above their benchmark. This does not mean that each manager will provide above benchmark performance in all periods! Managers have to be monitored and at times replaced.

The second is whether smaller investment managers (hopefully with a focus on minority owned and women owned firms) can provide competitive services. Again, the answer is yes. The very competitive record provided by a number of manager of emerging manager programs discussed by my associates should serve a proof statement that smaller firms can indeed compete. Further, focusing only on very large service providers and not aggressively pursuing smaller, innovative providers may well be detrimental to the interests of the Thrift Savings Plan participants.

Mr. DAVIS OF ILLINOIS. Thank you both very much. We will go into some questions.

Let me also just indicate and acknowledge that we have been also joined by Representative Elijah Cummings from the State of Maryland, and we are delighted that you have come, Representative Cummings.

Let me just ask you, perhaps, beginning, Mr. Swan. When I asked Mr. Long about market manipulation and possible political interests that people might have, he mentioned a couple of areas, and one of them happened to be the Real Estate Investment Trust. Do you see REITs and some other venture capital areas as necessarily risky or that much of a great risk as some people have suggested?

Mr. SWAN. Let me respond several ways. The first answer to your question is no, I don't see them as these terrible things. In fact, the response was—let me go to commodities, because that really jumped out at me. There was a suggestion by some commodities group that perhaps the TSP ought to look at a commodities fund. I would draw the distinction between looking at real estate, looking at venture capital, looking at private equity, looking at commodities, areas that may in fact enhance the return of the fund, as a good thing, and to take those suggestions as potential manipulation kind of baffles me a little bit. Indeed, they may be good suggestions, and I would ask the committee, maybe the committee might want to see the analysis upon which these manipulative suggestions were made, how they looked at it and why they rejected it.

Mr. DAVIS OF ILLINOIS. I have to admit that I have been somewhat baffled by some of this along the way, especially, as we look at how fluid things are and how some things remain fairly static, at least in terms of their being. One of the things that I thought about in terms of real estate is that you can't move it to China or someplace if it is in New York.

Mr. SWAN. Yes, sir.

Mr. DAVIS OF ILLINOIS. It is pretty difficult to do.

Mr. SWAN. And it is not going to be mass produced, either.

Mr. DAVIS OF ILLINOIS. Yes.

Mr. SWAN. There is only so much of it.

Mr. DAVIS OF ILLINOIS. The sectors with the highest returns or that are performing, say, better than some others might be performing, if one takes a look at those, does that necessarily mean that they are diminishing the protection of their clients?

Mr. SWAN. The answer is no. The higher performing sectors may indeed, over time, have more volatility, the returns may bounce up and down a bit more, but they tend to have higher volatility around a steeper performance trend line, a steeper positive performance trend line. It may mean that, for example, you limit, if you have a venture capital option or a pure real estate options, that you limit the amount that the plan participants could put into that option. But I am not sure that one necessarily says these should be non-viable options. These are areas that you cannot or are very difficult to index. Generally, they are not areas you would want to index.

Mr. DAVIS OF ILLINOIS. Mr. Hollingsworth, could you share with us some of the thinking that surrounded the Texas Teacher Retirement Fund deciding to change a little bit or to venture into another arena?

Mr. HOLLINGSWORTH. Mr. Chairman, this really sort of started when I first came on the board as a trustee back in 2002, as I indicated in my earlier remarks, and that in the next year to 18 months we proceeded to lose $35 billion of the plan's assets when the tech bubble burst. And some of us began to ask questions about why that was happening and whether we had the right asset mix in our portfolio, and it took several years for us to get there because of a couple of reasons. One, at the time, Texas Teachers, we had the lowest per member cost of any large U.S. plan in the country, and we wore that like a badge of honor. As we began to do our asset allocation study, the study impressed upon us that there was a cost for us to wear that badge, and the cost was being borne by the annuitants in the area of decreased returns to our system.

The other thing is we were basically the last bastion of internal management. We had over 90 percent, at one time, of our assets were internally managed by internal staff, essentially in an indexed form. So we realized, one, we weren't getting any alpha or any increased returns in these inefficient markets—the alternative assets, private equity, certain high-yield type strategies. Those were strategies that were performing well in some markets and we had no opportunity to participate in those returns.

So the board concluded that the best long-term asset allocation—again, this is a defined benefit plan, so this is these folks' only retirement—was to have a balanced portfolio where we were still a majority equity fund but, for example, we now have 10 percent of the fund allocated to private equity, 10 percent to real estate, 5 percent to real return, infrastructure, timber, 5 percent in the absolute return strategies, the hedge funds. So regardless of what is going on in the marketplace, we felt like we always had an opportunity to participate in what was doing well, and we also minimized our downside risk in those assets classes that were not performing well.

I mean, our fund right now is probably up 2 percent, which is not great. Had we not moved so much money out of our global equities portfolio, we would probably be down 6 percent or 7 percent. So having basically a beta fund, a stock and bond fund, means that you live and die with the stock market. When it is doing well, you make a lot of money; when it is not doing well, you lose a lot of money. So we thought a more balanced approach was a better one.

Mr. DAVIS OF ILLINOIS. Thank you, gentlemen, very well.

I will now go to Mr. Jordan.

Mr. JORDAN. Thank you, Mr. Chairman.

I too want to thank you both for coming here. Very compelling testimony from both of you.

Mr. Swan, your four points I thought were great, particularly the one that the passive strategy is not sacrosanct either; there are people making decisions about what elements are going to determine the benchmark itself. So I think that is a point well taken. The one thing, though, that you didn't talk about, and Mr. Hollingsworth has a little bit in his opening statement—and this was

the focus of Mr. Long's testimony and, frankly, the Members of Congress when they put together the act back in 1986, was making sure we do as much as we can to safeguard against political influence, political manipulation.

To me, that is what it comes down to, because you have done some good things in Texas to deal with this market we are in now. I mean, I looked at my Thrift Savings Plan quarterly report last time and it wasn't what we would have liked to have seen, so I understand that. But talk to me about what you would suggest to have those safeguards in place to deal with the political aspect of this.

And then, Mr. Hollingsworth, elaborate more on what you did in Texas when you said you moved to some partial active investment strategies, what you did to deal with the political question as well.

Mr. SWAN. I guess I am at a little bit of a loss because you have a defined contribution plan, it is huge, but there are defined contribution plans in many political settings. This is not unique. So I hear this concern about political manipulation, but I am not sure what the manipulation might be. The only example that was given earlier was that some people showed up—I don't know what the group was—and said, gee, you ought to look at commodities. Well, maybe that is a bad idea; maybe it is a good idea. But I have yet to hear an example of political manipulation. If someone has one, I would love to respond to it.

Mr. JORDAN. So you just think it is overstated.

Mr. SWAN. I think it is overstated and I think that——

Mr. JORDAN. And that is valid.

Mr. SWAN [continuing]. As long as those that are exercising their fiduciary responsibility and ultimately selecting the vehicles that the plan participants can then subsequently make their selections from, as long as those individuals exercise their fiduciary responsibility, I am not sure what the political manipulation is.

Mr. JORDAN. I think about the plan I was involved with, the deferred compensation plan—I have to go back and look at the particulars, but I believe it was designed as you just described.

Mr. Hollingsworth.

Mr. HOLLINGSWORTH. I agree with that. You know, I think this is a situation where there are examples. You hear stories where one or two incidents of situations sort of hit the news. When I became chairman of this board, some people perceived me as, I now have $110 billion to give out to people, so the phone started ringing and everybody wants to meet with you. So that is there. But I always took the approach with our board that we can put some things in place so that the information level is equal among board members. But I have never been one to think that you can legislate ethical behavior, so you have to hold each of your board members to their ethical and fiduciary responsibilities.

Now, having said that, when we did move to more strategies where the board and senior staff were more involved in meeting with managers, reviewing portfolios, making decisions, and obligating assets, we did do some things such as have certain ethical disclosures in place, such that when a board member met with a potential manager who wanted to be part of our private equity portfolio or part of our real estate portfolio, that information, under the

old policy, had to be disclosed. You had to disclose that information so that when that manager came before the board, that board member would reveal I have met with this individual, I am or am not biased, I think I can or cannot be objective in voting.

So I think there are some disclosure rules and some other things that you can do if there is concern about inappropriate influence on the investment process.

Mr. JORDAN. OK.

Mr. SWAN. None of these, by the way, if I might add, have anything to do with the efficacy of the plan and its ultimate goal, which I think should be how to help the participants maximize the amount of money that they have when they retire.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Jordan.

I thought Mr. Cummings was there, but I see he has left. I, then, just have one, perhaps, additional question. Given our purpose, how does each one of you view the possibility—and I think all of us want to make sure that fiduciary responsibilities are in place, and obviously that is inherent in any discussion. How do you see the possibility of some movement to provide opportunities that currently seemingly are distanced or, to some degree, does not exist?

Mr. HOLLINGSWORTH. I am sorry, the last part of your sentence dropped off, Mr. Chairman. What was that?

Mr. DAVIS OF ILLINOIS. I really was saying that it is difficult to break into this with minority companies. What do you see as a possibility?

Before I do that, though, let me ask Mr. Cummings if he has any questions. And if so, Elijah, go right ahead.

Mr. SWAN. There are two, I think, pretty obvious ways right up front. The first one is who do the providers of your investment service, who are their vendors? Who do they execute trades in, and in what kind of volume? That is one issue.

There is another issue, and that is—and it is a sidebar, it is only partial response to your question, and you asked it earlier—what does the staff of your vendors look like? Because that is also about opportunity.

Finally, over the last 10 years, there has been the development of something called managers of emerging managers. These are firms that hire smaller firms, many of which, if not most of which, are women-owned and minority-owned firms, package them so that, indeed, large plan sponsors can hire the firm and give it a lot of money. It is very difficult to give a lot of money to a firm that only manages $20 million. But if a minority firm or woman-owned firm comes to the table and they have $1 billion under management, or $2 billion or $3 billion, then a very large plan can do business with them, and should be able to do business with them; and that is the economic function that managers of managers provide. And I think you will hear testimony from someone from one of the very excellent firms, and they have produced terrific returns on an active basis.

Mr. HOLLINGSWORTH. And that is the way we have approached it at Texas. Manager managers, fund to funds, as they are also referred to. We instituted a small and emerging manager program that we are basically going to have in every asset class and every strategy, and basically you are hiring a manager that goes out and

evaluates these funds. The dollars can be allocated different ways, but typically the dollars are allocated to the fund-to-funds manager, and that fund-to-funds manager then has discretion to distribute those dollars in smaller increments to small and emerging managers.

It just so happens that because of the recent emergence of minorities and women in this space, if you are investing in a small and emerging manager program, be it in private equity, be it in global equities or real estate, you are inherently going to be developing and increasing the number of relationships that your entity has with women and minority-owned firms completely consistent with your fiduciary duty.

Our small and emerging manager program does a few things. First, it typically gives us access to strategies sectors where those managers are more on the ground and have more access to. But we are also looking for those great investors, those investors who are going to be the stars of the future. So we are helping to build, many times, these small and growing firms into substantial firms that can come back and in which we can invest directly into them, because they have size, they have bandwidth, they have the track record, they now have the experience.

So instead of going through a fund-to-funds, where they may get an allocation between $5 million to $25 million, we can then invest in that fund directly at amounts up to $500, $600, $700 million. So we are trying to have a relationship with the stars of the future, but also help grow and build firms that have the requisite skill and abilities to help us in our fiduciary duty.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Mr. Cummings.

Mr. CUMMINGS. This whole issue takes me back to Maryland, when I was in State legislature trying to make sure that minority firms had an opportunity to participate. In Maryland, we had a situation, of course, where a huge percentage of our employees were minorities and they were concerned, as were members of the legislature, that when it came to participation investments, minorities were basically locked out. It was not a question of whether it was fair; it was unfair and it was basically an old boys system, and the old boys system basically said we have done it this way and we are going to continue to do it this way.

The second thing that they said implicitly was that they feared that if this money was put under the jurisdiction of minority firms, that because many of them were new, as compared to some of the older firms, that they worried about what might happen to the money. It was deep. So we had a situation where, if you took particularly the latter argument, the question is when do those firms get the opportunities to even grow, to not only grow, but to survive and then thrive.

So that leads me to—I was listening to all you are saying here—what do you—and maybe you said this—what do you all see that the legislature—this is the Congress—should be doing to basically level the playing field? I am just wondering what you had in mind.

Mr. HOLLINGSWORTH. Well, I will address a couple things we did. In Texas, we did not have authority to do a number of things.

Mr. CUMMINGS. I am sorry, you didn't have what?

Mr. HOLLINGSWORTH. We did not have the authority to do a number of things at the pension plan. And I haven't really looked in depth at the TSP to really know exactly what its legal authorities are, but, for example, we had to go to the legislature and get authority to use external managers in our program, and we went to the legislature and basically laid out that there were these inefficient areas, that we didn't have the expertise on staff, we needed the ability to go out and take advantage some external managers who were really good at what they did.

We also talked about the fact that we were going to use fund-to-funds, as well, to help us get access to these younger, smaller funds that are just starting out, because what the fund-to-funds does is it gives a little bit of cover, because they have gone through one level of scrutiny already. So the legislature gave us the approval to put out up to 30 percent of our plan's assets to external managers, so equivalent to about $30 billion or so.

So, again, I haven't looked in depth to the TSP to know where you are constrained right now, but most plans do require some level of authority to begin to use external managers. From the presentation I heard earlier, I guess you are mandated legally to invest passively, so obviously I think you would have to go and seek some sort of legislative approval for some active management so that you could take advantage of some of those other less efficient markets out there and use some other creative strategies to make sure that you have a balanced portfolio here at TSP.

Mr. SWAN. What many, if not most, small firms, minority firms, women-owned firms do, the sector that they are involved in, or the sectors, are precisely the sectors that would allow the plan participants the opportunity to maximize their total accumulation. Again, I keep coming back to that point that index funds aren't the issue. The issue is how do you help plan participants maximize their accumulation. There are very powerful arguments that women and minority-owned firms are operating in those sectors—active equity, to some extent active fixed income, even now in the international area, venture capital, private equity. These are sectors that can drive return well executed.

Mr. HOLLINGSWORTH. I would add one more point, if I might, Representative Cummings. Texas is a defined benefit plan, so our board makes the decisions for the annuitants. You have a defined contribution plan, so it is just a matter of what choices they have as relates to options.

When we created the portfolio that we did that was balanced and diversified, one option to think about—you were asking us about ways to do this—would be maybe to have a pooled option, meaning you have one option for your members that is a diversified fund where a certain percentage is in equities or maybe a small segment to private equity, there might be a small segment to real estate. I know there is always the concern of protecting your annuitants from themselves. You don't want them to go out and put all their money in a fund that is all private equity or all real estate, but maybe an option where it is a pooled opportunity where they are diversified across several asset classes, maybe that is an option that could be added to a defined contribution plan.

Mr. CUMMINGS. One last thing, Mr. Chairman.

I think there are so many of us who get frustrated, and it is not just in this area, but it is in a lot of areas, and there are all kinds of excuses that are found not to be inclusive and not to have a diverse group of folk working on these kinds of issues. Some kind of way we have to come to a solution so that we can have some impact. Other than that, our grandchildren will be talking about these same issues and opportunities will have passed so many people by and so many people will have been deprived of the opportunities to grow and to be a participant.

I will never forget my father—Mr. Chairman, I will be real brief—my father, who only had a first grade education, he had one accident in his life, automobile accident, and that accident came 3 days after I got admitted to the bar, and he said, I want you to take my case. I said, Daddy, I don't know nothing about accident cases; I just got admitted to the bar. And he said something that I will never forget. I said, why do you want me to do this? He said, if I don't use you, who is going to use you?

So we prepare our young people to go forward, to be the best that they can be; we educate them, we give them opportunity—and it is not just young people, but people—and they do the right things and then they have this window called life, their life, and when the window is shut, game over, opportunity lost. So I just want to work with our chairman to see what we can do to try to address the rest of these issues.

Mr. SWAN. I don't know if there is a legislative remedy embodied in this, but one of the things that I think is very helpful is if those that are making the decisions about who is hired are a diverse group.

Mr. HOLLINGSWORTH. I will add just one other point to that, and I think you will probably hear more of this later with some of the other panelists. I have always thought that these small emerging manager programs were important. Not everybody agrees. Not even all my board members agreed when I first became chair. But I think what you might hear about later is that I think the empirical evidence is now there to make the business case that small and emerging managers, which includes a lot of women and minority-owned funds, are simply out-performing their counterpart. So that is a bit more compelling when there may be those who don't share the same sentiments. So I think you have to go to a much, much stronger case now.

Mr. SWAN. One of the things that certainly could be done is to ask the GAO to participate in a survey about changing the law to allow active management. That would open the door potentially to greater accumulation on the part of the plan participants and greater opportunity on the part of the vendors.

Mr. DAVIS OF ILLINOIS. Well, thank you, gentlemen so very much.

Mr. Swan, at the end of your opening statement you sort of said I hope that my testimony will be beneficial. Well, I can tell you that both of your testimony has been very beneficial. We appreciate the fact that you have come and shared with us, and we thank you so very much.

Mr. SWAN. Thank you, Mr. Chair.

Mr. HOLLINGSWORTH. Thank you, Mr. Chair, for having us.

Mr. DAVIS OF ILLINOIS. We will then proceed to our next panel. Our third panel, while they are being seated, consists of Mr. Thurman White, who has been chief executive officer of Progress Investment Management since 2004. Progress is a leader in creating emerging manager of manager portfolios for a diverse group of clients. We welcome you, Mr. White.

Ms. Mellody Hobson is the president of Ariel Capital Management, a Chicago investment firm. And I might also indicate that they are headquartered in my congressional district and I consider them to be one of my most prized constituents and we are delighted that they are there. She is also the chairman of the Board of Trustees of Ariel Mutual Funds and a spokesperson for the Annual Area Swap Black Investor Survey. Ms. Hobson, we welcome you and thank you.

Mr. Jesse Brown is a principal at Krystal Investments. He has worked extensively with deferred compensation retirement plans and is an author who has written extensively on investment and the generation of capital, especially Black capital, I would assume, although, all of it is green.

Of course, it is our tradition that witnesses be sworn in, so if you would stand and raise your right hands.

[Witnesses sworn.]

Mr. DAVIS OF ILLINOIS. The record will show that the witnesses answered in the affirmative.

We would appreciate it if you would summarize your statement in 5 minutes. Of course, your entire statement is in the record. The lights indicate timing, and we will simply be governed by what is going on. Thank you very much.

We will begin with you, Mr. White.

STATEMENTS OF THURMAN WHITE, CHIEF EXECUTIVE OFFICER, PROGRESS INVESTMENT MANAGEMENT; MELLODY HOBSON, PRESIDENT, ARIEL CAPITAL MANAGEMENT, INC.; AND JESSE BROWN, PRESIDENT, KRYSTAL INVESTMENTS

STATEMENT OF THURMAN WHITE

Mr. WHITE. Thank you, Mr. Chairman. Thank you for allowing me to have the opportunity to appear before you this morning, and thank you for convening this hearing on a very important topic for our industry. Again, my name is Thurman White, and I am president and CEO of Progress Investment Management Co., located in San Francisco, CA.

For the past 18 years, our firm has had extensive experience working exclusively with large institutional investors who are looking to, one, access new investment talent and, second, capture the above-market returns that talent can provide. This pool of under-researched and under-utilized talent is what we refer to in the industry today as emerging managers. Typically, this includes smaller entrepreneurial firms, in many cases less than $2 billion to $3 billion in assets under management, who are maybe new in their investment firms but are not new investors. Many of these owners and portfolio managers and emerging manager firms have gotten experience at large investment houses and have left to start their own firms. So that is the niche within which we specialize.

I would like to make three brief points and then conclude. The first is that emerging managers do add value; the second point is that diversification makes a meaningful difference; and the third is that best practices among large institutional plans are inclusive, and not exclusive.

With respect to the first point, emerging managers do add value. Many times there will be some question as to why take the risk of hiring emerging firms? Aren't they inexperienced? Aren't they in fact more risky than large firms? The simple answer is no. Again, as I mentioned, the fact that they are emerging, the fact that they may be minority and women-owned firms does not mean that they are inexperienced investors. In fact, we manage $7 billion in assets for 29 institutional clients. We work with 60 firms in 20 different multi-management investment portfolios. Now, when we did a recent survey of the experience level of the portfolio managers and founders of our firms, we found that 70 percent of those who had founded and started those firms had more than 20 years of investment experience. So these are not new investors.

More importantly, because of their passion, because of their commitment, because of their access now to technology, because of their certainly absence of bureaucracy, and, more importantly, in most cases these are employee-owned firms, which means there is an alignment between their economic interest, their professional and financial interest, these are some qualitative reasons that these firms out-perform.

But as you heard earlier, our own investor performance on behalf of our clients, the investment performance of others in the industry, as well as a growing body of academic research all support the notion that emerging and minority-owned firms do out-perform market benchmarks; they do out-perform, in many cases, their larger counterparts, and particularly in the inefficient asset classes, both in bull and bear markets, and that is particularly relevant given the kind of market volatility that we have had most recently. In the small-cap areas, mid-cap areas, emerging managers do out-perform both benchmarks, as well as the large firm counterparts.

The second point I would like to kind of focus on is this idea of diversification and it does make a difference in terms of institutional portfolios. Diversification is a time-honored and kind of proven strategy for mitigating all kinds of risk. Diversification of the kinds of managers that a plan may work with; diversification in terms of the kinds of strategies that an institutional investor may employ.

Now, the interesting thing that we have in the situation with the Thrift Savings Plan is you have both single manager and specific company risk. Quite unusual to have such a large pool of assets managed by one firm. As we have seen most recently with a lot of the large investment firms, there are a lot of unexpected, unknown, certainly unintended risk that are resident in those firms. So having that single manager and specific kind of manager risk is a bit unusual.

The second thing that you have here is a single style risk, and that is the risk of the market. Again, this is something that perhaps poses an undue risk for the Federal employees and retirees that are participants in this plan, and that risk, again, is a market

risk. When a market is doing well, as you have heard, annuitants do well. When the market is doing poorly, as we have had in the last few months, annuitants do not do as well. So having a single style, a passive style risk, again, is perhaps an undue risk, and certainly one could question the fiduciary responsibility of the Thrift Investment Board and its advisory council for exposing annuitants to that level of undue risk.

Finally, this idea of best practices in the industry being inclusive, and not exclusive. In Exhibit 2 in my written testimony, we have identified over 50 defined benefit, primarily, pension plans, institutional investors of a size and stature and certainly similar investment objective to the Federal Thrift Savings Plan. These 50 funds probably represent a couple of trillion dollars in assets. All of them have utilized targeted investment strategies to be inclusive of emerging and minority investment firms.

Why have they done this? Not for social reasons, not for political reasons, but for performance reasons. They want to win in the global marketplace. They want to diversify the range of managers that they work with; they want to get access to new talent, to the innovation and new ideas that small businesses bring to management and investment portfolios. They also want to build on and create opportunities for the next generation of talent to make the industry itself more competitive.

So these are the reasons that all of these pension plans have utilized—and increasingly, also, defined contribution plans are beginning to utilize—emerging and minority investment firms.

Finally, I would like to conclude with a bit of an analogy. Since it is the summer, it has to do with baseball and sports. As we have seen, we have seen this paradigm, whether it is entertainment, whether it is politics, in a variety of industries, and that is, simply, this: whenever the playing field is leveled and new participants are allowed to participate, the game is enriched. We saw this in baseball after World War II, when Branch Ricky of the Brooklyn Dodgers wanted to do one thing, he wanted to win. So like the Thrift Savings Plan, there was this pool of talent in the Negro baseball leagues that had been overlooked and not used at all. So Branch Ricky, of course, identified Jackie Robinson, brought him in to major league baseball, and the rest is history.

Similarly, even out in San Francisco, with our Giants, there was a scout there, a man by the name of Alex Pompeii, who also knew of another under-utilized, overlooked pool of talent, and that was Latino-based ball players in the Caribbean and South America. So he began to scout that area, signed people like Juan Marichal and Orlando Sepeda and the Allou brothers, and that brought in another underused pool of talent and the game was enriched.

So as we think about these issues with respect to the Federal Thrift Plan and the other Federal retirement plans, if we can make them more inclusive, make them include the talent potential and performance potential of emerging and minority managers, and have active investment strategies be a part of their overall asset allocation, I think the Federal retirees and employees will be similarly enriched and will have a win-win situation.

Thank you for the opportunity to be here. I would be happy to answer any questions you have.

[The prepared statement of Mr. White follows:]

"Investing in the Future: Minority Opportunities and the Federal Retirement Thrift Savings Plan (TSP)"

TESTIMONY OF THURMAN V. WHITE, JR.
PRESIDENT AND CEO
PROGRESS INVESTMENT MANAGEMENT COMPANY, LLC
SAN FRANCISCO, CALIFORNIA

Before the

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND DISTRICT OF COLUMBIA
HON. DANNY K. DAVIS, CHAIRMAN

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U. S. HOUSE OF REPRESENTATIVES

JULY 10, 2008

Mr. Chairman and Members: First, I would like to thank you for the opportunity to appear before you today, and also thank you for convening this hearing on such an important topic to our industry.

My name is Thurman V. White, Jr. President and CEO of Progress Investment Management Company, LLC (hereafter "Progress"), an employee-owned certified minority business enterprise and registered investment adviser. Progress has an 18-year track record of excellence in asset management. Today we manage almost $7 billion in assets for many of the nation's premier public and corporate institutional investors. Progress has been a pioneer in the area of managing "emerging managers", which includes minority and women-owned investment firms. Progress serves institutional clients as a manager of managers developing diversified emerging manager investment portfolios in various asset classes – equity, fixed income and private equity strategies. We execute our investment strategy by identifying and using new investment talent -- "emerging" investment managers -- that may often be overlooked and/or underutilized by traditional pension fund consultants and large pension plans. We then use these firms to create diversified, risk-controlled multiple manager investment strategies to deliver competitive investment returns.

In my testimony today, I'd like to make three brief points on why emerging managers are indeed an appropriate investment for the future, and should be an integral part of the asset allocation for the Federal Retirement Thrift Savings Plan (TSP) and other federal plans

such as the National Railroad Trust, PBGC and others. In addition, our firm has recently prepared two white papers on these issues (available via our website at www.progressinvestment.com), one of which I'd like to incorporate by reference for the record in this proceeding, and have attached hereto.

Who Are "Emerging Managers"?

Simply defined, emerging manager is a specialized industry term. Historically the term was synonymous with minority firms but it has evolved. Today, the term identifies promising investment managers who, by virtue of their relatively short firm investment track record and/or relatively small amount of firm or product assets under management, are traditionally overlooked by pension plans and their consultants in the searches that typically determine who manages institutional pension fund assets. In most cases, the industry has looked to total firm size, i. e. assets under management, as the primary definitional criteria for emerging firms. Today, "emerging manager' most often means those firms that are less than \$2—3Billion in assets under management, and that are independently owned (at least 51% of the firm is owned by individuals working in the firm). Many minority-owned asset management firms in our industry fall within this category of "emerging managers" since they have less than the threshold \$2—3B in AUM, and are relatively new firms. Thus, "emerging manager" includes, but is not limited to, minority and women-owned firms.

Progress maintains its own proprietary database of emerging investment firms. Criteria for inclusion in the Progress emerging manager database are SEC-registered investment advisers with: 1) at least 51% independent ownership by employees of the firm; 2) less than \$2B in assets under management; and 3) all minority and women-owned managers, regardless of size. Our Progress database now comprises close to 900 emerging firms managing over 1800 investment strategies in U. S. and non-U. S. equities, fixed income and alternative strategies. Exhibit 1 depicts a graphic snapshot of our current Progress database and the relative size, ownership status and strategy diversity represented within this fast growing emerging manger universe.

Why Hire Emerging Managers?

Many U. S. plan sponsors – with the notable exception of the federal retirement plans that are the subject of today's hearings – invest with emerging mangers in targeted strategies. These strategies are designed to capture emerging manager alpha potential (excess returns above market benchmarks), to access new talent and secure future manager capacity, and to provide more opportunities for newer and smaller firms to diversify the industry.

These large U. S. institutional investors – both corporate plans as well as public plans (states, counties and municipal entities) have committed billions of dollars in assets to targeted emerging manger investment strategies for one reason—they want to win in global capital markets!

With investment firms, size does matter – but not as traditionally perceived. There is a growing body of academic research that supports the fact that small, entrepreneurial investment firms, i. e., emerging managers, can and often do outperform their larger counterparts. See Footnote 1. In addition to this research, the investment returns of firms like Progress and others in this industry represent solid proof that there's no loss of investment performance or undue risk when using emerging, minority and women-owned investment firms. In fact, one can consistently achieve market-competitive returns through emerging manager investment strategies.

Another reason to hire emerging managers is the diversification they bring to institutional portfolios. The investment management industry is conservative by nature, and slow to change. Despite actual portfolio results and research to the contrary, many institutional investors still perceive bigger as better and, therefore, prefer the large investment firm names that we're all too familiar with instead of seizing the opportunity to hire less well-known small entrepreneurial firms including those asset managers runs by talented minorities and women (many of whom got their initial experiences with larger firms then left to start their own firms). Ironically, the fact is there may well be more unintended risk in those portfolios managed by large firms than investors realize. The huge non-transparent mortgage derivative losses and write-downs suffered by large investment banks, and the recent demise of Bear Stearns, illustrates the many unknown and unexpected risks in large investment firms.

Hiring emerging managers can mitigate the large firm concentration risk that may be generally evident in many retirement plan portfolios, and specifically in the portfolios run by the Federal Thrift Savings Plans. Having such a large pool of assets managed by a single manger is very risky. Such single manager concentration runs contrary to prudent investment policy that typically looks to asset class as well as manager diversification as an efficient means to diversify risk and enhance returns in today's volatile market. In fact, we can question whether the TSP and its Advisory Council are upholding their fiduciary responsibilities to the Plan's beneficiaries by failing to adequately diversify manager as well as asset class risk (discussed below) within the TSP.

Finally, hiring emerging managers is a means to not only provide opportunities to new investment talent but also a means to foster new ideas and investment innovation.

Industry "Best Practices" and How Other Large U. S. Pension Plans Use Targeted Emerging Manager Investment Strategies

Exhibit 2 provides a partial list of all of the U. S. pension plans that have utilized targeted emerging manager investment strategies to enhance overall investment returns, diversify their portfolios and reduce manager concentration risk, and provide opportunities for entrepreneurial firms to incubate and deliver new ideas and innovation to the industry – all to benefit the beneficiaries of these plans. That the Federal Retirement Thrift Savings Plan is not listed among these plans is shameful, and frankly puzzling.

Use of emerging mangers has become institutionalized in our industry. And this is a trend that appears to be growing. Many plan sponsors are utilizing emerging manager investment strategies in various asset classes – equities – U. S. and non-US; fixed income; private equity, real estate and even in hedge fund strategies. Not surprisingly, there are talented and competent minority and women-owned investment firms managing assets successfully in each of these asset classes. There are also emerging, and minority and women –owned managers managing enhanced passive strategies as well.

Many other U. S. plans have also sought to diversify the range of investment strategies within their respective asset allocations to include both active as well as passive investment strategies. Again, there may be as much diversification risk with using only one type of investment strategy, e. g., exclusively passive strategies like those of the Federal Retirement Thrift Savings Plan, as there would be in having only one political party in a democratic election. In either case, the risk of limited choice is too great a risk. The loser in such situations is the federal retirement beneficiaries – or in the case of a single party election – democracy itself.

Conclusion

The attached position paper outlines a range of best practice options and proven asset allocation ideas that the Federal retirement plans can use to invest in emerging managers. By doing so, the Federal plans can enhance their investment returns, diversify the types of managers in their portfolios, and provide opportunities for new ideas and innovation within their respective asset allocation policies.

I will conclude by providing an analogy that is often used by Rev. Jesse Jackson and his Rainbow PUSH/Wall Street Project that is appropriate here. It's a sports analogy about America's favorite pastime – baseball.

Much like we've seen in other industries, when the playing field is broadened to be more inclusive, everyone wins. After WWII, Branch Rickey of the Brooklyn Dodgers saw a pool of overlooked baseball talent that operated outside the mainstream of Major League Baseball as it was known then. That pool of "emerging" talent was the Negro Baseball League. Branch Rickey also knew one thing – he wanted to win. So Rickey began to scout the Negro Leagues and ultimately brought Jackie Robinson in as the first African American to play in Major League Baseball; the rest is history. Similarly, in San Francisco a few years later there was a Major League Baseball scout for our SF Giants named Alejandro ("Alex") Pompez. A former owner of the Negro League New York Cubans, Pompez knew about another pool of overlooked and unused talent in the Caribbean and South America – Latino baseball players. So Pompez began to scout this talent and signed several Latin American players on behalf of the SF Giants -- players like Juan Marichal, Orlando Cepeda, the Alou brothers and others. These were players of enormous ability who, when given the opportunity to enrich and make the game more competitive, did so and raised the level of play for everyone.

And our national pastime, and the many baseball fans, are the beneficiaries of this more inclusive brand of Major League Baseball as we know it today.

I believe that the same "win/win" phenomena can happen with the Federal Retirement Thrift Savings Plan, The National Railroad Trust, the Pension Benefit Guaranty Corporation and other federal plans. However, this win/win will only happen if the Federal plans become more inclusive, use emerging managers including minority investment firms and allow us to provide the benefits of alpha, diversification and diversity for their portfolios.

Thank you for the opportunity to appear before you today. I will be happy to answer any questions you may have.

Footnote:

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Footnote -- continued

Leading Edge Investment Advisors. "Performance Characteristics of Emerging Managers" - 2006

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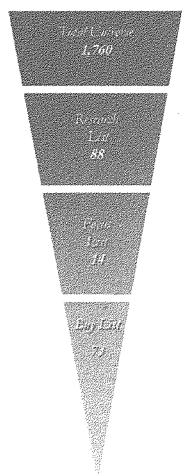
EXHIBIT 1 — THE PROGRESS DATABASE

Manager Research and Focus List (Strategies)



By Style

	All	African-American	Asian-American	Disabled	Emerging	Latino-American	Native American	Minority Unclassified	Woman-Owned	Women + Minority
Fixed Income - Cash Mgmt	30	9	2		13	1			5	
Fixed Income - Core	168	40	8		91	7			22	
Fixed Income - Core Plus	12	2	1		5	1			3	
Fixed Income - High Yield	27	1			17	1			8	
Fixed Income - Int. Rate Forecasting	68	5	2		51	2			8	
Fixed Income - Other	126	12	7		85	3			18	1
International Fixed Income	23	1			11	1			9	1
International Equity	110	4	7		83			1	12	3
Large Core or All Cap	402	22	12		319	3			46	
Large Growth	215	23	7	1	156	2			26	
Large Value	135	15	2		100	2	1	2	13	
Mid Core	31	5	1		21				3	1
Mid Growth	54	5	2		41	1			4	1
Mid Value	43	7			31	2			3	
Small Core	57	3	3		46				4	1
Small Growth	96	4	2		80	5			2	3
Small Value	77	8	3		58	1			7	
SMID Core	11				10				1	
SMID Growth	21	1	1		16				2	1
SMID Value	13	1	1		10				1	
Other	28	4						7	17	
Other - Equity Specialty	13	1		2	7				3	
Totals:	**1,760**	**173**	**61**	**3**	**1,251**	**32**	**1**	**10**	**217**	**12**

By Size & Ownership

	All	1-50	50-100	100-500	500-1000	1000-2000	> 2000
African-American	173	16	5	40	21	32	59
Asian-American	61	8		25	6	1	21
Disabled	3						3
Emerging	1251	161	110	435	254	265	26
Latino-American	32	6		8	8	7	3
Native American	1				1		
Minority Unclassified	10	7		1			2
Woman	217	44	29	38	45	27	34
Woman/Minority Owned	12				4	8	
Totals:	**1,760**	**242**	**144**	**547**	**339**	**340**	**148**

Specifications:

1,760 Strategies

All developing managers with less than $2B

All woman- and minority-owned managers

At least 51% independently-owned

· Registered Investment Advisors only

PROGRESS INVESTMENT MANAGEMENT COMPANY

EXHIBIT 2

PARTIAL LIST OF U.S. PLANS USING EMERGING MANAGERS

The following is a representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies:

- **1199SEIU Employees Benefit and Pension Funds**
- **Alameda County Employees' Retirement Association**
- **Arkansas Teacher Retirement System**
- **Bank of America Corporation**
- **Boeing Company**
- **Boulé Foundation**
- **California Public Employees' Retirement System**
- **California State Teachers' Retirement System**
- **Chicago Policemen's Annuity & Benefit Fund**
- **City of Kansas City Employees' Retirement System**
- **City of Philadelphia Board of Pensions and Retirement**
- **Coca Cola Master Retirement Trust**
- **Contra Costa County Employees' Retirement Association**
- **Detroit General Retirement System**
- **District of Columbia Retirement Board**
- **Exelon Corporation**
- **GE Asset Management**
- **Illinois Municipal Retirement Fund**
- **Illinois State Board of Investment**
- **Indiana Public Employees' Retirement Fund**
- **Liberty Mutual Retirement Benefit Plan**
- **Los Angeles City Employees' Retirement System**
- **Los Angeles County Employees Retirement Association**
- **Maryland State Retirement & Pension System**
- **Massachusetts Bay Transportation Authority Retirement Fund**

Exhibit 2 – continued

- Michigan Department of Treasury
- Municipal Employees' Annuity & Benefit Fund of Chicago
- New York City Board of Education Retirement System
- New York City Employees' Retirement Systems
- New York City Fire Department Pension Fund
- New York City Police Pension Fund
- New York State Common Retirement Fund
- New York State Teachers' Retirement System
- Ohio Public Employees Retirement System
- Oregon Public Employees Retirement Fund
- PG&E Corporation
- Pennsylvania Public School Employees' Retirement System
- PPL Services Corporation
- Public School Teachers' Pension & Retirement Fund of Chicago
- San Antonio Fire & Police Pension Fund
- San Francisco City & County Employees' Retirement System
- San Joaquin County Employees' Retirement Association
- Seattle City Employees' Retirement System
- Shell Oil Company
- State of Connecticut Retirement Plans & Trust Funds
- State Universities Retirement System of Illinois
- Teacher Retirement System of Texas
- Teachers' Retirement System of the City of New York
- Teachers' Retirement System of the State of Illinois
- The Pennsylvania Treasury Department
- Verizon Communications, Inc.

Successful Emerging Manager Strategies for the 21st Century

Thurman V. White, Jr.

About the Author

Thurman V. White, Jr. is President and Chief Executive Officer of Progress Investment Management Company, LLC, a pioneering specialist in developing emerging manager investment portfolios. For the past 16 years, Mr. White has served in a variety of leadership roles at Progress. In 2004, he and a team of senior executives led the firm's management buyback, resulting in Progress becoming an independent, employee- and minority-owned investment company. Founded in 1990 and with $7 billion in assets under management today, Progress is recognized as the industry's largest and most experienced manager of emerging managers. Currently, Progress works with 60 emerging firms, managing 25 multi-manager investment portfolios for some of the world's largest, most sophisticated institutional investors.

In a previous article, I pose a straightforward question: "Given the evolution and growing popularity of emerging investment managers, why aren't these entrepreneurial firms more broadly represented in institutional investor portfolios?" The purpose of this article is twofold: (1) to attempt to answer that question, and (2) to promote increasing investment in emerging managers by sharing portfolio allocation strategies and best practices.

Definitions of "emerging manager" vary depending on the goals of the investor. In 2008, "emerging manager" most often means "small" in terms of assets under management ($2 to $3 billion or less), independent (at least 51% employee-owned) and sometimes, but not always, firms owned by women or minorities.

Often, these are smaller companies created by an exodus of talent from larger investment firms. "Emerging Managers," says Joseph J. Haslip, Assistant Deputy Comptroller for Pensions for the New York City Retirement Systems, "have the same talent, educational background and acumen as the people at the larger firms, but they have opted to be more entrepreneurial." The City of New York, through its five different pension funds, has invested approximately $7 billion, or 6% of assets totaling $114 billion, with emerging managers through diverse investment strategies.* *(For more on New York City's innovative, diversified approach to pursuing emerging manager returns, see separate box on Page 5.)*

More Possibilities For Alpha

U.S. plan sponsors invest with emerging managers to capture their alpha potential, to provide more opportunities for newer and smaller firms, and to access new talent and future manager capacity.

Many studies over time have shown that small, employee-owned investment companies outperform their larger competitors.[1] It has almost become a truism in our industry that the greater the assets under management (AUM), the less the likelihood of outperformance. The inverse relationship between assets and alpha (assets up, alpha down) is part of the reason that many global investment firms position themselves as a group of small "boutiques" operating under the umbrella of their parent company.[2]

Says a public-fund investment officer and longtime Progress client, "When managers reach a certain level of assets under management, their risk becomes losing assets under management as opposed to market risk." Consistent with this perspective, this public plan's domestic-equity portfolio is almost totally indexed—except for two strategic allocations to active managers: Progress and another firm. Through strong performance and additional asset awards of $270 million, the Progress portfolio has grown from $100 million to more than $1 billion during the past 10+ years.

* As background for this article and a companion article, we conducted interviews with selected Progress clients. We share their views here, with permission, on a for attribution and, in some cases, not for attribution basis.

Practical and Psychological Barriers To Entry

Despite the proven performance advantage of emerging firms, barriers to entry remain high. From a purely practical standpoint, it is impossible for many institutional investors to invest a meaningful percentage of assets with any one emerging firm. Restrictions often disallow pension plans from making an investment that would become more than a certain percentage of any one manager's asset base. Usually this limit ranges from 10% to 30%. For example, if a new firm has $100 million under management and a plan sponsor wants to invest $100 million, that plan would become 50% of the emerging manager's asset base, which may be disallowed by the plan's risk policy.

Research by Progress, however, has shown that only 15% out of 312 new mandates from $1 to $99 million—allocation sizes for which many emerging firms would qualify—were awarded to emerging firms.[3] What does this mean? It means that practical hurdles such as asset size constraints are far less significant than psychological hurdles.

The investment business is, by temperament and history, conservative and slow to change. Many investors still perceive bigger as being quite simply better, and many still prefer the known—the household names—to unknown start-ups run by entrepreneurs (many of whom, paradoxically, chose to exit employment with the household names). Whether consciously or not, these investors still would rather partake of the predictable mediocrity of a global fast-food franchise than take a calculated risk on a small, unknown diner with very possibly spectacular food.

Traditional pension fund consultant screens—e.g., minimum size and/or product track record—by definition reinforce conservative biases against emerging firms. Such screens exclude from competition talented new firms with significant performance potential. This is true even when these emerging firms are led by experienced industry professionals with strong prior performance track records.

None of these barriers has blocked the inevitable march toward change. Consultants may not always proactively perform due diligence on emerging managers and recommend the best emerging managers to their clients. But that hasn't stopped their clients from coming to them with requests for information about emerging managers. During a panel discussion at a Progress annual conference, a noted consultant said, "Pension fund consultants as a group are not the leading edge. We are the trailing edge. I got into [emerging managers] when my client said, 'we want to do this.'" [4]

"Part of The Mainstream of Investing"

More and more institutional investors are coming to their consultants and saying, "We want to do this. We want to find some good emerging managers." In fact, there is solid fiduciary support for initiating an emerging manager investment strategy. In our own Progress multi-manager portfolios, for example, 24 of 29 equity and fixed-income funds have outperformed their respective benchmarks since inception for the period ending May 31, 2008, including several with more than 10-year track records.[5]

While plan sponsors frequently refer to these strategies as "programs," these portfolios are just like any other equity, fixed-income or non-U.S. investment strategy. Says New York City's Mr. Haslip, "The real goal of these programs is to get to a point of comfort where you don't need separate programs, to where they become part of the mainstream investing."

Consistent with this view, emerging strategies are evaluated by the same investment metrics plan sponsors use to evaluate any other investment strategy—e.g., accepted industry investment benchmarks and standard risk metrics such as tracking error and information ratio targets. Similarly, plan sponsors should expect their staffs, consultants or manager-of-managers to conduct the same due diligence and use the same criteria to evaluate emerging firms that they use in evaluating well-established companies with substantial AUM.

The primary objective of an emerging manager investment strategy is to deliver investment returns. The additional benefits of diversity, manager diversification, opportunity and inclusion, while important policy considerations, nonetheless are secondary.

Strategies for Investing in Emerging Managers
Investment Vehicles

EXHIBIT 1 - The following is a representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies.

U.S. Pension Plans
1199 SEIU Employees Benefit and Pension Funds
Alameda County Employees' Retirement Association
Arkansas Teacher Retirement System
Bank of America Corporation
Boeing Company, The
Boulé Foundation
California Public Employees' Retirement System
California State Teachers' Retirement System
Chicago Policemen's Annuity & Benefit Fund
City of Kansas City Employees' Retirement System
City of Philadelphia Board of Pensions and Retirement
Coca Cola Master Retirement Trust
Contra Costa County Employees' Retirement Association
Detroit General Retirement System
District of Columbia Retirement Board
Exelon Corporation
GE Asset Management
Illinois Municipal Retirement Fund
Illinois State Board of Investment
Indiana Public Employees' Retirement Fund
Liberty Mutual Retirement Benefit Plan
Los Angeles City Employees' Retirement System
Los Angeles County Employees Retirement Association
Maryland State Retirement & Pension System
Massachusetts Bay Transportation Authority Retirement Fund
Michigan Department of Treasury
Minnesota State Board of Investment
Municipal Employees' Annuity & Benefit Fund of Chicago
New York City Board of Education Retirement System
New York City Employees' Retirement System
New York City Fire Department Pension Fund
New York City Police Pension Fund
New York State Common Retirement Fund
New York State Teachers' Retirement System
Ohio Public Employees Retirement System
Oregon Public Employees Retirement Fund
Pennsylvania Public School Employees' Retirement System
Pennsylvania Treasury Department, The
PG&E Corporation
PPL Services Corporation
Public School Teachers' Pension & Retirement Fund of Chicago
San Antonio Fire & Police Pension Fund
San Francisco City & County Employees' Retirement System
San Joaquin County Employees' Retirement Association
Seattle City Employees' Retirement System
Shell Oil Company
State of Connecticut Retirement Plans & Trust Funds
State Universities Retirement System of Illinois
Teacher Retirement System of Texas
Teachers' Retirement System of the City of New York
Teachers' Retirement System of the State of Illinois
Verizon Communications, Inc.

As emerging managers clear barriers to entry by providing competitive performance, they have grown significantly in number. Not only have their numbers increased, but today there also are many different ways to invest in emerging firms:

Manager-of-Managers (MoM)

Investing in emerging firms through a manager-of-managers has become popular for many reasons. The manager-of-managers approach allows a plan sponsor to invest in a portfolio of emerging managers through a

single point of contact, the MoM. This eliminates the concern noted earlier about becoming too large a percentage of any one manager's asset base. Just as an investor can achieve diversified exposure to micro-cap stocks through a fund, investors achieve diversified exposure to emerging managers through a manager-of-managers. And likely broader, more timely and efficient exposure than a plan sponsor might achieve otherwise through hiring directly—especially if this is the investor's initial foray in this strategy.

For many plan sponsors with limited resources, hiring emerging managers becomes possible by using a manager-of-managers, for several reasons. The manager-of-managers performs due diligence in selecting managers, monitors the managers and rebalances the portfolio, hiring and firing as necessary. The MoM also may provide expert assistance to emerging firms in managing their businesses, just as general partners assist portfolio companies in a private equity portfolio.

Private Equity Fund-of-Funds

Similar to MoMs in the public markets, several plan sponsors have used a private equity fund-of-funds as a means of implementing emerging manager investment strategies. Various Illinois public pension plans, the Virginia Retirement System and the Teacher Retirement System of Texas are among those that have taken this approach in private equity.

Multiple Manager-of-Managers Relationships

A new development is for investors to hire more than one manager of emerging managers with the goal of achieving specialist focus on complementary investment mandates. For example, one large public plan sponsor has as many as four MoMs, each focused on an equity sub-asset class and/or fixed income. These investment strategies are small-cap (Russell 2000 benchmark); non-U.S. equity (MSCI EAFE) and fixed income (custom Lehman Aggregate/Emerging Markets Index); and two MoMs focused on broad equity markets (Russell 3000 benchmark). The New York City Retirement Systems, the New York State Common Retirement Fund, the California State Teachers' Retirement System, the Los Angeles City Employees' Retirement System and several corporate plans are among those that have hired multiple MoMs to implement their respective emerging manager programs.

Direct-Hire

Working with a general consultant, a specialist consultant or with pension staff alone, several pension plans have chosen to hire emerging managers directly. Examples include the Minnesota State Board of Investment and the Illinois State Board of Investment. Several plans, including the nation's largest public plan, the California Public Employees' Retirement System, as well as the Los Angeles County Employees' Retirement Association, have also adopted direct-hire emerging manager programs focused on alternative strategies such as private equity, hedge funds and real estate. In these situations, a plan will invest with an emerging firm as part of its overall asset allocation in the same way that it invests with other external managers. Due to the relative size of emerging managers, the plan in some cases will hire emerging firms for somewhat smaller asset mandates than for other active external managers. As the emerging firms perform, the plan can award larger asset mandates, or even fund more than one product from the same emerging manager.

MoM and Direct Hire

The Illinois Municipal Retirement Fund, the State Universities Retirement System of Illinois, New York City Employees' Retirement System and Shell Pension Trust are all examples of plan sponsors that have hired emerging managers directly and used a manager-of-managers. This dual strategy assures a complementary, comprehensive approach using different criteria for direct versus MoM hiring. For example, in one case a public plan invests directly with larger emerging firms (those with more than $1 billion in AUM), while investing through its MoM in a multi-manager portfolio of emerging firms with $1 billion or less.

Direct Equity Investment

In this model, a plan sponsor takes a hybrid venture capital/public markets approach to investing with emerging managers, providing both operational capital and assets to manage. The plan sponsor potentially receives the benefit of both investment returns on the managed assets and venture capital-like returns when the plan exits its direct equity investments in the emerging managers. The plan will work with an external partner to form an investment fund (partnership or limited liability company) through which the partner can make both the direct private-equity investment in the firm as well as provide assets to manage on the plan sponsor's behalf.

A Nuanced, Thoughtful Approach to Capturing Emerging Manager Alpha

"Because domestic equity isn't what it used to be"

As part of its strategy to pursue alpha in non-traditional ways, New York City's pension plans have invested in emerging managers across asset classes and through diverse investment vehicles, including multiple manager-of-managers and direct relationships.

Not content to accept industry definitions by rote, New York City has created two emerging manager classifications for investing in the public markets: "emerging managers", with zero to $1 billion under management and "developing managers", with $1 billion to $5 billion. "We want to have more exposure to smaller managers in the public marketplace because domestic equity just isn't what it used to be," says Deputy Comptroller for Pensions, Joseph Haslip.

In private equity, New York City defines "emerging" as zero to $400 million under management in first- and second-time funds; in real estate, emerging is defined as zero to $300 million in first- and second-time funds. New York City also is in the process of evaluating a seeding program to make direct private-equity investments in emerging managers.

Providing seed money to emerging managers adds business risk to investment risk, and therefore must be weighed carefully, says Mr. Haslip. He nonetheless views seeding as "an integral component to keep a stable of top-performing talent in the market."

The California Public Employees' Retirement System (CalPERS) has championed this form of emerging manager investment strategy through its first-of-a-kind Manager Development Program (MDP). Since 2000, Progress has had the privilege of working in partnership with CalPERS, along with another service provider, in implementing the CalPERS MDP strategy. One of the most successful MDP graduates from the Progress portfolio to the CalPERS mainstream lineup is Arrowstreet Capital, a Boston-based, quantitative, international equity manager.

Strategies for Investing in Emerging Managers

Asset Allocation Considerations

Once the plan sponsor has decided upon the investment vehicle or vehicles, the next key decision is, "Where will our emerging manager allocation fit within our total portfolio?"

There are many different approaches to answering this question, depending upon the structure of the plan, the proposed allocation to emerging managers and the plan's philosophy of managing assets.

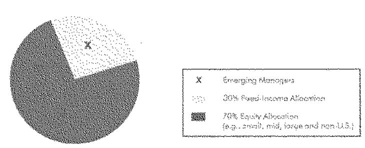
The exhibit below provides a simplified representation of different ways to allocate assets to emerging managers within the portfolio as a whole.

EXHIBIT 2 - Emerging Managers Asset Allocation Models

Part of the Total Allocation

Model 1

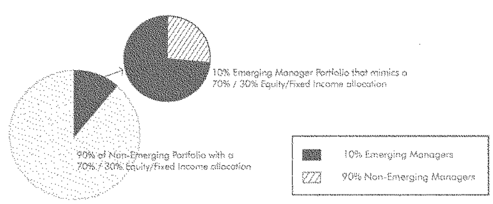
An equity/fixed-income allocation including emerging managers as part of the overall portfolio.



A Separate Allocation

Model 2

A separate emerging manager portfolio mimics the asset allocation of the overall portfolio.



In Model 1, emerging managers are included in the total asset allocation along with non-emerging managers, consistent with the investor's definition of emerging—e.g., $2 billion or less. Model 2 shows a different approach, whereby emerging managers are considered a discrete portfolio designed to mimic the asset allocation of the overall, non-emerging portfolio.

The Maryland State Retirement and Pension System and, more recently, the New York State Common Retirement Fund have developed a best-in-class approach to investing with emerging managers. Both plans created guidelines requiring the MoM to choose only the emerging managers with the highest performance potential, regardless of the benchmark. The goal of these plans is to assemble, through the MoM, a best-in-class emerging manager portfolio as opposed to an optimized fund. The plan sponsor then adjusts the portfolio as a whole for any unintended asset class or factor bets (e.g., size) generated by the best-in-class portfolio.

Strategies for Investing in Emerging Managers

10 Best Practices

We have considered different investment vehicles and asset allocation strategies. Now let's consider 10 best practices to facilitate alpha capture by emerging manager investing.

1. **Do not treat emerging managers as separate or different—it's all about alpha.** In the article preceding this one,[6] I discussed the origin of the term "emerging manager program" as a euphemism for "entitlement program for investment companies owned by women and minorities." Emerging managers today include talented money managers regardless of ethnicity, and the success of these programs in meeting diversity initiatives can be attributed directly to defining "emerging manager" in the broadest possible terms. In setting up an emerging manager investment program, investors should keep a sharp focus on what matters most: strong, long-term investment performance for pension plan beneficiaries.

2. **Incorporate the emerging manager program into the plan's overall investment policy.** As with all aspects of plan governance, the goals and fiduciary philosophy of an emerging manager program should be incorporated into the plan's investment policy statement. Regardless of whether the policy mandates an explicit portfolio allocation (see Best Practice #3 below), the emerging manager strategy should become institutionalized as a long-term part of the plan's mission. It should not be subject to bureaucratic whim or the loss of institutional memory that may occur due to turnover in a plan's trustees, staff or consultant. Says New York City's Joseph Haslip, "We thought it was critical to memorialize this [commitment to emerging managers] in our investment policy. ... Sometimes you wonder why these pension plans didn't have these [emerging manager] programs before, and it's no secret why they didn't. Oftentimes, people don't approach investing in emerging managers with the same level of openness to new ideas."

3. **Let performance dictate the size of the allocation over time.** Some emerging manager programs initially establish a fixed allocation for the program—e.g., 1% to 3% of the total portfolio. Placing a ceiling on the initial emerging manager allocation may make sense as a clearly delineated starting point. But we believe that the asset size of the program should reflect its success, and many investors have grown their programs systematically as a function of positive performance. "The reason we allocate more money to our emerging managers is simply because they do well," says one of our clients, the chief investment officer of a mid-sized financial institution. "Our attitude is, 'Emerging managers are competitive—put them on the list!' As opposed to, 'We want to reserve some portion of our allocation specifically for emerging managers.'" Says another Progress client, an investment manager at a large corporate plan: "We have dedicated a portion of our plan to emerging managers. But there is no set dollar amount or percentage. We want to keep our strategy open-ended, to be able to invest more or less in emerging managers based on the opportunities available." This approach allows emerging manager allocations to grow not according to some arbitrary ceiling or quota but according to merit and opportunity.

4. **Be proactive in considering emerging manager sources of alpha—do not rely on your consultant.** You are a pension plan sponsor. One morning, you will be sitting at your desk and your general pension plan consultant will call you and say, "Have you considered emerging managers? They could add a lot of alpha to your plan's portfolio." And then you will wake up and realize it was all a dream. The reality, as one consultant has pointed out, is that plan sponsors—not their consultants—are promoting investment in emerging managers—and rightfully so. To initiate or expand an emerging manager strategy, you will need to be proactive and explicitly directive with your traditional consultant—or work with a specialist consultant or manager-of-managers.

5. **Be dynamic about the size definition of "emerging manager."** In an earlier article,[7] I discussed how a key definition of "emerging"—size of AUM—has evolved with the growth of the asset management industry. In 1990, when Progress began investing in emerging managers, we defined "emerging manager" as $500 million or less. Today, we define it as $2 billion or less, and some of our corporate clients have raised their emerging manager ceilings to $3 billion and even to $5 billion, depending upon the asset class (e.g., higher for fixed-income managers due to different scale considerations). It is important to not let the definition that guides your program remain static when the world around you is changing. When the largest asset managers have grown to more than $1 trillion in AUM, for example, you may need to ask, "Is $2 to $3 billion still an appropriate ceiling for an emerging firm?" By raising this ceiling with the growth of industry AUM, institutional investors broaden opportunities for smaller companies while broadening their own universe of alpha possibilities.

6. **Clarify how the definition of "emerging" should operate.** Another implementation issue that raises compliance concerns is how to treat firms that grow beyond the size definitions written into program guidelines. Many plan sponsors have chosen to define emerging managers as those with less than $2 billion in AUM. But what happens when a firm grows successfully beyond that $2 billion ceiling? Is that firm still an "emerging manager"?

Our experience at Progress suggests that the firm should still be considered emerging. If such a firm does not maintain its emerging status, then it may fall into a no-man's land too large for the emerging program but too small to be considered for direct-hire or stand-alone mandates. This results in a program anomaly that doesn't create a "win/win" for clients or emerging firms. The key here is whether the emerging firm is below the AUM ceiling at the time of funding the manager for the program. An emerging firm that outperforms and demonstrates the capacity to gather and manage additional assets should be awarded additional assets—not penalized. As long as that firm fits the asset size definition at time of funding and continues to outperform, our preference is to allow that firm to remain in our programs regardless of subsequent AUM size—or to graduate the firm to direct-hire assignments with our clients. (Also see Best Practice #10 on the merits of establishing a clear graduation policy at the start of an emerging manager investment strategy.)

Experienced Emerging Manager Professionals

- More than 50% of founders or portfolio managers have 11 to 25 years of industry experience before founding their firms
- 76% of key portfolio managers have 16 to 25 years of experience
- 62% of key portfolio managers have more than 25 years of experience

Based on a 2006 study of the Progress funded-manager universe of 60 emerging firms

7. **Stimulate product innovation through program flexibility—fund emerging products as well as emerging firms.** As the emerging manager universe has matured, emerging firms have become adept at developing new investment products. A Progress study shows that, although many of these firms are new and/or smaller in size, most are led by veteran investment industry professionals (see sidebar opposite). Not-withstanding their professional experience and relative success in performing and gathering assets, many firms nonetheless still face significant barriers to entry when introducing new products. This holds true even for companies with total firm AUM far in excess of the typical $2 billion to $3 billion ceiling. We, therefore, believe that the next generation of emerging manager program design should allow more flexibility to:

   (1) seed new products of funded emerging firms (subject to the new product successfully meeting the investor's due diligence criteria)

   (2) seed and include emerging products from firms larger than the program's AUM ceiling, where such products are otherwise competitive and suitable for a client portfolio

   (3) fund other innovative investment strategies in an "opportunistic" portfolio component

   In no event should this opportunistic component of an emerging manager strategy represent more than 10% to 15% of total emerging manager program assets.

   Progress has had positive experiences funding the second generation of products from existing funded firms with proven alpha engines, personnel and processes. We also have had positive experiences funding the second

generation of emerging firms—i.e., start-ups where the founder comes from a previously funded Progress emerging manager. Many of our emerging program mandates, however, unfortunately do not allow us the flexibility to exploit these potential alpha opportunities on behalf of our clients. We believe that greater program flexibility not only would provide more alpha possibilities, but also would stimulate product innovation and make emerging managers more competitive for the future.

8. **Extend emerging manager allocations across asset classes.** In most existing emerging manager programs, asset allocation has been focused largely on U.S. equities, followed by U.S. fixed-income, U.S. private-equity and, more recently, non-U.S. equities. Hedge funds (many of which by definition are emerging firms) are likely the next asset class where institutional investors will seek emerging talent. The experience and quality of emerging manager portfolio managers, as well as the breadth of products now available from emerging firms, support the extension of emerging manager program allocations to all asset classes:

   Traditional Asset Classes
   U.S. and non-U.S. equities—across styles and market capitalizations
   U.S. and non-U.S. fixed-income—including core, core-plus, high-yield and convertible strategies

   Alternative Asset Classes
   Private Equity—venture, buyout and distressed
   Real Estate—core and opportunistic
   Hedge Funds—including absolute-return, market-neutral and long/short strategies

9. **Consider whether to invest directly or via an emerging manager-of-managers, or both.** Just as investors dipping a toe into the waters of private equity often start with a fund-of-funds, many plan sponsors initiate their investment in emerging managers through a multi-manager portfolio run by a manager-of-managers. This makes sense because selecting emerging managers is time-consuming and requires a different skill set from that used to select established firms. Many of the traditional performance-measurement techniques simply do not apply or must be applied with considerable insight.

   In making the decision to invest directly or through a manager-of-managers, a plan sponsor needs to consider the size of its staff and its capacity to monitor additional smaller managers. As discussed earlier in this article, plan sponsors choose the MoM approach as an efficient way to gain access to multiple emerging managers through a single, expert point of contact.

   As emerging managers grow their assets with continued strong performance, the plan sponsor gains familiarity and comfort with certain managers and may decide to hire those managers directly (see Best Practice #10 below). Rather than terminate the MoM relationship, many of these plans graduate the top-performing managers to direct-hire relationships, while retaining the MoM as an evergreen conduit to fresh new talent.

10. **Establish a well-defined graduation policy at the start of the program.** A clearly planned graduation or exit strategy for emerging firms can create an even more compelling motivation for emerging managers to perform and grow. Over the years, we have urged our clients to think about this important component of their emerging manager investment strategies at the program inception stage—i.e., before they have a need for new talent. Perhaps the most compelling reason for an emerging firm's transition to a stand-alone mandate is a client's need for an emerging firm's style-specific capabilities in its overall asset allocation. Another primary benefit for a plan sponsor is to leverage its emerging manager talent pool to mitigate future manager-search expense by using top-performing firms for future direct hire or mainstream assignments.

    In addition to asset growth, the graduating manager should have sufficient tenure in the program and sufficient operational, reporting and compliance infrastructure to instill confidence in its ability to manage a significantly larger mandate. Many institutional-client stand-alone mandates for external managers range from $100 million to $500 million. Several Progress clients have successfully incorporated a graduation component as an integral part of their emerging manager programs. The Public School Teachers' Pension & Retirement Fund of Chicago and the New York State Common Retirement Fund are leading examples, with multiple emerging direct-hire graduates.

The Opportunity To Compete = An Opportunity For Everyone To Win

Emerging managers do not want special favors. They want an opportunity to compete. But the biggest barriers to true competition are still fear of change and comfort with the status quo. If pension plans continue to invest primarily in household names based on this comfort factor—and our research shows that they do—they are doing an immense disservice to their beneficiaries. Despite the proven performance track record of these talented, entrepreneurial firms, institutional investment portfolios on average have invested only a small percentage—typically 1% to 3% of their assets—in emerging investment strategies.

At Progress, our mission is to change this practice by crafting innovative alpha strategies that deliver value for investors. In partnership with our clients, our vision is "to become the company most known for changing the face of the investment management industry." By removing unneeded barriers and granting emerging managers the opportunity to compete, institutional investors democratize capital, thereby making the investment industry as a whole more robust and competitive—a better future for all.

Based upon investment performance and sound fiduciary policies, our hope is that more institutional investors will embrace these proven investment strategies. As a result, when we build successful emerging manager investment programs, we create "win/win/win" synergies—for clients and their beneficiaries, for emerging managers, and for our industry.

This is the second in a series of publications by Progress designed to share the firm's experience in creating emerging manager investment programs. We want to help the investment industry better understand the issues, strategy options and best practices associated with developing emerging manager programs. For more information, please contact Mona Williams, Executive Vice President, Marketing & Client Service (mwilliams@progressinvestment.com).

Footnotes

1. For a complete bibliography of studies documenting the performance advantage of investing with emerging managers, please visit www.progressinvestment.com.
2. White, Thurman, "Small Isn't What It Used to Be: The Changing Face of Smaller Investment Firms," June 2003, the Institute for Fiduciary Education.
3. Ibid.
4. "What the Research Tells Us About Emerging Managers," panel discussion of the 2004 Progress Plan Sponsor and Emerging Manager Conference, Scottsdale, AZ. Note: This panelist has co-authored one of the most comprehensive, authoritative studies on emerging managers, "A Review of Emerging Managers and Developing Manager Programs," April 2003, by Allan Emkin, Neil A. Rue, CFA, Jeremy Thiessen and Sandra Parker. This paper is available under "Research" at www.pensionconsulting.com.
5. Progress Investment Management Company, LLC - Investment Committee Report, p. 1, May 2008
6. White, Thurman, "From Diversity to Diversification—The Evolution of the term 'Emerging Manager,'" July 2008.
7. Ibid.

Mr. DAVIS OF ILLINOIS. Thank you very much. We thank you for your testimony.

We will go to Ms. Hobson.

STATEMENT OF MELLODY HOBSON

Ms. HOBSON. Thank you very much. Thank you, Chairman Davis and Ranking Member Marchant, as well as members of the subcommittee. My name is Mellody Hobson, and I am president of Ariel Investments, an executive board member of the Investment Company Institute and a board member of NASP. I greatly appreciate the opportunity to be here today and provide you with a brief overview of our firm, our business, and our larger social mission.

Our chairman and CEO, John Rogers, founded the firm in 1983 when he was just 24 years old. Based in Chicago, Ariel Investments serves individual investors and 401(k) plans through our no-load mutual funds. Additionally, we manage separate accounts for large corporate, public, union, and non-profit organizations. Throughout our firm's 25-year history, patience has served as the bedrock of our investment philosophy and approach to building our firm. By adhering to a consistent and disciplined approach, we have grown from 2 to 100 employees, with $8.9 billion in assets under management. Currently, we have more than 1.4 million investors in our mutual funds.

As the country's first African-American-owned money management firm, we have a unique viewpoint and perspective on the retirement challenges facing our County. Even today, we are still the only minority firm with mutual funds priced daily in the newspaper.

Just to give you a little insight on our investment approach, we look for leading brands in established industries with high quality management teams.

We analyze all financial statements to ensure that we are buying financially strong businesses.

As value investors, we don't just buy cheap stocks; we buy quality businesses at very low prices.

The financial industry has recognized our firm's performance in a number of ways. Through our research process, our discipline, and our focus, we have established a proven long-term track record, a record that has been widely, widely recognized in the media.

On the specific question of active versus passive management in the Thrift Savings Plan, I would say that over the long haul many money management firms, including ours, have out-performed the market. I am a firm believer in active management, and want to make that clear. The greatest investor of all time, Warren Buffet, has proved this success over and over again.

But there is a larger issue at stake. The question of who is being left behind in defined contribution retirement plans, like the ones we are moving toward, rather than the defined benefit system that is rapidly disappearing from many corporations, and even some sectors of government.

The harsh fact is that minorities, who have less exposure, experience, and comfort with the stock market, we as a community are falling behind. That is why, in addition to our corporate mission to manage money for our clients and to give them exemplary returns,

we also have a social mission to promote saving and investment and wealth-building in minority communities. My personal goal is to make the stock market a subject of dinner table conversation in the Black community.

To that end, for the past 10 years, we have partnered with Charles Schwab and Co. on an annual survey comparing saving and investment habits of Black and White Americans. We have released the results each year to highlight the barriers to greater wealth-building among African-Americans, including the lack of knowledge and exposure, the lack of trust in financial services industry, partly due to the lack of diversity in our industry; and historical preferences that keep us from the stock market. Because of these factors, we have learned that our community typically has half as much money saved for retirement as our White counterparts at the same income levels.

We were very hopeful that the story will be different in large corporations that offer company-sponsored retirement plans, but in the first few companies that we checked, we found alarming discrepancies between Black and White savings rates, sometimes by a factor of three or four. Many of us as a community do not even contribute enough to take advantage of the company match, the free money that companies give us for participating in the plan. We also have learned that African-Americans tend to borrow more against 401(k) plans, we are less diversified in our investment choices, and less likely to roll over our retirement money into an IRA when we switch jobs.

Recently, we secured a significant grant from the Rockefeller Foundation to conduct a study with leading benefits administrator on minority participation in 401(k) plans at America's largest corporations. That work is just beginning and we are very hopeful that we will be able to spark a national conversation to boost minority participation in company-sponsored retirement plans.

Finally, and most importantly, we are introducing financial literacy programs in the Chicago public schools to help educate future generations of African-American children on the importance of saving and investing. At Ariel, we have sponsored a public school called the Ariel Community Academy for over a decade that teaches inner-city children how to invest in the stock market using $20,000 per class of real money. When they graduate, they are allowed to keep their profits and have them matched with up to an additional $1,000 if they invest in a 529 plan for their college savings.

So you can see, beyond our reputation as a leading investment firm for our long-term results, Ariel has also established itself as a national expert on minority saving investment habits and a leader in promoting financial literacy in our community. Our research suggests that proactive and targeted efforts on the part of employers, especially in seeking out minority managers, can help minorities who work in government and private sector to invest at a level that secures and guarantees a comfortable retirement for them.

We welcome any and all opportunities to be involved and appreciate your giving me the opportunity to speak on this issue.

[The prepared statement of Ms. Hobson follows:]

TESTIMONY OF MELLODY HOBSON
PRESIDENT
ARIEL INVESTMENTS

Before the

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA
HON. DANNY K DAVIS, CHAIRMAN

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U. S. HOUSE OF REPRESENTATIVES

"INVESTING IN THE FUTURE: MINORITY OPPORTUNITIES AND THE FEDERAL RETIREMENT THRIFT SAVINGS PLAN (TSP)"

JULY 10, 2008

INTRODUCTION

Thank you Chairman Davis and Ranking Member Marchant and members of the Subcommittee. My name is Mellody Hobson and I am the President of Ariel Investments, an executive board member of the Investment Company Institute and a board member of NASP. I greatly appreciate the opportunity to be here today and provide you with a brief overview of our firm, our business, and our larger social mission.

Our Chairman and CEO John W. Rogers, Jr., founded the firm in 1983 when he was just 24 years old. Based in Chicago, Ariel Investments serves individual investors and 401(k) plans through its no-load mutual funds. Additionally, Ariel manages separate accounts for corporate, public, union and non-profit organizations. Throughout our 25-year history, patience has served as the bedrock of Ariel's investment philosophy and approach to building the firm. By adhering to a consistent and disciplined approach,

Ariel has grown from 2 to 100 employees with $8.9 billion in assets under management. Currently, we have more than 1,450,000 investors in our mutual funds.

As the country's first African American owned money management firm we have a unique viewpoint and perspective on the retirement challenges facing the country. Even today, we are still the only minority owned mutual fund company in America whose prices are listed in the daily newspapers.

Just to give you a little insight into our investing approach, there are more than 15,000 publicly traded stocks on the market, but our three funds have a combined total of just 55 holdings.

That's because we only buy what we believe in. We look for leading brands in established industries with high quality management teams. We analyze all financial statements to ensure that we are buying financially strong companies.

As value investors, we don't buy cheap stocks: we buy quality stocks at low prices. Our focus is primarily on small and mid cap companies because they have room to grow—and on unloved ones because when they return to favor their stock prices appreciate more quickly. Altogether this is a good recipe for great long-term returns.

OUR TRACK RECORD

The financial industry has recognized our performance in a number of ways: Through our research process, our discipline and our focus we have established a proven track record over the past 25 years. According to fund rating service Lipper, Ariel Fund ranks 2nd out of 7 Mid-Cap Core Funds for the since-inception period beginning November 1986 and ending March 2008. Lipper also lists Ariel Appreciation Fund as ranking 13th out of 45 Multi-Cap Core Funds since its inception in 1989 through March 2008. Investment analysis firm Morningstar includes Ariel Appreciation as an Analyst Pick in the Mid-Blend category, meaning that it is one of its highest-conviction recommendations.

On the specific question of active vs. passive management of the thrift savings plan, I would say that over the long haul, many money management firms, including ours, have outperformed the market. I am a firm believer in active management and the greatest investor of all time, Warren Buffett, has proved its success many times over.

But there's a larger issue at stake. The question is who is being left behind in a defined contribution retirement system like the one we are moving towards – rather than the defined benefit system that is rapidly disappearing from many corporations and even some sectors of government?

The harsh fact is that minorities – who have less exposure, experience and comfort with the stock market—are falling behind. That is why – in addition to our corporate mission to manage money for our clients – we also have a social mission to promote saving,

investing and wealth-building in the minority community and specifically to bring the topic of saving and investing to the dinner table of every African-American family.

To that end, for the past ten years we have partnered with The Charles Schwab Corporation on an annual survey comparing the saving and investing habits of middle- and upper-income Blacks and Whites. We have released the results each year to highlight the barriers to greater wealth-building among Blacks – including lack of knowledge and exposure, lack of trust in the financial services industry in part due to the lack of diversity, and a historical preference for real estate. Because of these factors, we have learned that Blacks typically have half as much money saved for retirement as Whites with similar incomes.

We were very hopeful that the story would be different in large corporations offering company-sponsored retirement plans, but in the first few companies where we checked – we found alarming discrepancies between Black and White savings rates – sometimes by a factor of three or four. Many do not even contribute enough to take advantage of the company match. We have also learned Blacks borrow more against their 401k plans, are less diversified in their investment choices and are less likely to roll-over their retirement savings when switching jobs.

Recently we secured a grant from the Rockefeller Foundation to conduct a study with a leading benefits administrator on minority participation in 401(k) plans at America's largest corporations. That work is just beginning and we are very hopeful that this study

will inform a national conversation on ways to boost minority participation in company-sponsored retirement plans.

Finally, and most importantly, we are introducing financial literacy programs into public schools to help educate future generations of African-American children on the importance of saving and investing. We have sponsored a public school in Chicago, called the Ariel Community Academy, for over a decade that teaches inner-city children how to invest in the stock market. We give each incoming first grade class a portfolio of $20,000 in real money to invest. When they graduate, we allow them to keep their profits or have them matched with an additional $1,000 if they choose to invest in a 529 plan. Additionally, we are now working with the public schools in Chicago to expand this program to other schools.

Through all of these efforts, Ariel has established itself as a national expert on minority saving and investing habits and a leader in promoting financial literacy in our community. Our research suggests that proactive and targeted efforts on the part of employers, especially in seeking out minority managers, can help minorities who work in the government and private sectors invest at a level that guarantees a secure and comfortable retirement. Ariel welcomes any opportunity to be involved.

CONCLUSION

Thank you for inviting me to speak on this important issue. I look forward to your questions. My colleagues at Ariel and I would welcome the chance to work with you on the issues related to minority investment managers.

Mr. DAVIS OF ILLINOIS. Thank you very much.

We will go to Mr. Brown.

STATEMENT OF JESSE BROWN

Mr. BROWN. Thank you, Mr. Chairman. It is my honor to be here to add to the discussion of the importance of improving minority access in the management of the Federal Thrift Savings Plan. I am giving my perspective from someone who has little, if anything, to individually gain from the results of this discourse, but, more importantly, I have an interest in the topic from a fairness in the whole financial arena perspective.

Because we only have so much time today to discuss this topic, I would like to reserve the right to revise and extend my remarks for the record at a later date, with the permission of the chairman and the members of the committee.

Mr. DAVIS OF ILLINOIS. So ordered.

Mr. BROWN. Let me be clear. The statement "improving minority access" implies there is access. But the access is wanting, not good enough, inadequate, deficient.

But is that really the case? From where I sit, Mr. Chairman, that access is not deficient, it is simply not there.

Mr. Chairman, the Federal work force is more than 50 percent historically under-represented ethnic and racially diverse individuals, as committee Member Norton indicated earlier. Likewise, that diversity should be reflected in the enrollment and professional advice given and available to all the plan participants. We all know that advice is very important in the financial arena, so who better to give that advice then people who share the culture and common interests of those who are actually investing their money?

The dilemma is that the criteria for competing for the opportunity to manage the Federal Thrift Savings Plan "is capability of managing billions of dollars." The fact of the matter is African-American and other minority-owned companies do not manage billions of dollars or maybe I should say manage less than the status quo, except for one or two firms which have been mentioned here today. Therefore, minority managers cannot bid on these proposals until the criteria for eligibility has been changed.

What I want to leave with you today is not only a discussion about what has evolved over time, where there is now a monopoly, if you will, in place, but I want to make sure that you understand that there is an opportunity to change the current practices and create so much more good with just a few and a little more attention of the course and the willingness to embrace diversity at its highest and most significant level. I am talking about inclusion, Mr. Chairman.

This is the 21st century, and I know I don't have to tell you that much has changed. I must say, as one who traditionally is very deliberate about change, much of the change we have experienced with diversity has been for the greater good. Let's face it, we all know an inclusive environment can enhance the status of much of what we do in our day-to-day life. We have all read the studies, heard the presentations by experts in the field like R. Roosevelt Thomas, who has published several books on diversity and has a consulting firm, or Bea Smith, founder of the Kaleidoscope Group

years ago who is a leader in the whole area of diversity, and more than likely we have pretty much experienced the positive outcomes of diversity ourselves on a daily basis. So I don't pretend to be telling you anything that you don't know.

If we can just take what we have learned from other arenas and apply it here, I believe we would agree that diversity participation at the management level of the Federal Thrift Savings program and the investment companies that are fiduciaries of those accounts can offer opportunities for inclusion, as well as serve as a catalyst for improved decisionmaking, increased productivity and make a competitive advantage. You might ask the proverbial question, if it ain't broke, why fix it? Let's not get too comfortable with the familiar, Mr. Chairman. The practice of offering American businesses the opportunity to participate is inherent in our existence.

At the very minimum, Mr. Chairman, I think the principles of affirmative action, or, should I say, diversity should take force. Even the very large and successful contractors of the Federal Thrift Savings program have a very poor record of diversity in their own work force. I would welcome the committee's aggressive demand upon all of the contractors to the Federal Thrift Savings Board and the Thrift Savings Plan itself to set and meet goals of internal minority employment, hiring and promotion. They should be able to name individuals of minority groups that head major divisions of their firm. They should report back to the committee their hiring practices and recruiting practices. They should show that they are doing everything they can to meet the goals of the industry as a whole, and especially as relates to the management of the Federal Government employees' money.

For that matter, the Federal Thrift Savings Board itself is not diverse. Has there ever been an African-American or woman appointed to the Board? Why not? Diversity begins at the top.

Mr. Chairman, the executive director of the Federal Thrift Savings Board should be challenged and directed to begin the diversity movement within his own office and staff, and then in the various departments and divisions. This should be a part of every vendor's report, the number of minorities that are employed. And if there are none, why, and what recruiting efforts are under way.

So reaching these goals should be a criteria for compensation of the executive director and his staff, beginning at the Federal Thrift Savings Board itself, and should be legislated as part of his job description and responsibility.

In closing, the Federal Thrift Savings Board should be about Federal employees, and not just the administration of the funds. The employees should be first in the minds of the Federal Thrift Savings Plan. At this point, the Federal Thrift Savings Board and the administration primarily worry about managing the funds. They give off the responsibility of educating the members of the Federal Thrift Savings Plan to the Office of Personnel Management. This could be legislated in a different way as time moves on.

With that, I will conclude my remarks and answer questions, and leave the rest for the credit document.

[The prepared statement of Mr. Brown follows:]

"Investing in the Future: Minority Opportunities and the TSP" Thursday,
July 10, 2008, 10:00 a.m. Room 2154, Rayburn House Office Building.
Presenter: Jesse B. Brown

The Subcommittee

Improving minority access in the management of the Federal Employee Thrift Savings Plan (TSP).

Thank you very much Mr. Chairman. It is my honor to be here to add to the discussion of the importance of improving minority access in the management of the Federal Employee Thrift Savings Plan (TSP). I am giving my perspective from someone who has little if anything to individually gain as a result of this discourse, **but more importantly,** has interest in this topic from fairness in the financial arena perspective.

Because we only have so much time today to discuss this topic, I would like to reserve a right to revise and extend my remarks for the record at a later date with the permission of the Chairman and members of the committee.

Let's be clear. The statement "Improving minority access" implies there **is** access,- -------------- but the access is wanting, not good enough, inadequate, ...deficient.

But, is that really the case? From where I sit Mr. Chairman , **that access is not deficient, it is simply not there.**

Mr. Chairman, the federal work force is more than 50% historically under represented ethnic and racially diverse individuals; **their investment managers should reflect that same face of diversity.** And likewise, that diversity should be reflected in the enrollment and professional advice available to the plan participant. We all know that advice is very important in the financial arena, so who better to give that advice than people who share culture and common interest.

The dilemma is that the criteria for competing for the opportunity to manage the Federal Employee Thrift Savings Plan (as stated in the RFP) and I quote is "capability of managing billions of dollars" And, the fact of the matter is---

African American and other minority owned companies **do not** manage billions of dollars, manage less than the status quo. Therefore **Minority managers can not bid on these proposals until the criteria for eligibility have been changed.**

What I want to leave with you today is not only a discussion about what has evolved over time where there is now a monopoly if you will, in place; but I want to make sure you understand that there is an opportunity to change the current practices and create so much more good, with just a little more attention, and of course the willingness to embrace diversity at its highest and most significant level. I'm talking about **inclusion Mr. Chairman.**

This is the 21st Century, and I know I don't have to tell you that much has changed—and I must say as one who is traditionally deliberate about change, much of the change we've experienced with diversity has been for the greater good. Let's face it; we all know an inclusive environment can enhance the status of much of what we do in day to day life. We've all read the studies, heard the presentations by experts in the field, from R. Roosevelt Thomas has published several books on Diversity and has a Consulting Firm to Bea Smith founded Kaleidoscope Group years ago and was a leader in Diversity, and more than likely we've all pretty much experienced the positive outcomes of diversity--- so I don't pretend to be telling you anything you don't already know.

If we can just take what we've learned from other arena's and apply it here, I believe we'd all agree that diverse participation at the management level of the Federal Employee Thrift Savings Plan and the investment companies that are the fiduciaries of the accounts can offer the opportunity for inclusion, as well as serve as a catalyst for improved decision making, increased productivity, and a competitive advantage. You might ask the proverbial question, "If it ain't broke, why fix it?" Let's not get too comfortable with the familiar Mr. Chairman ----the practice of offering American businesses RFP's that continue to support the success of the majority, are inherently racially discriminatory, and should no longer exist.

At the very minimum Mr. Chairman I think the principals of Affirmative Action should take force. Even the very large and successful current contractors of the Federal Thrift Savings program have very poor records of diversity in their own work force. I would welcome this committees aggressive demands upon all the contractors to the Federal Thrift Savings Board and the Thrift Savings plan to set and meet goal of internal minority employee hiring and promotion. They should be able to name individual members of minority groups that head major divisions of their firm. They should report back to the committee their hiring practices and recruiting practices. They should show that they are doing everything they can to meet the goals of the industry as a whole and especially as it relates to the management of the federal government employee's money.

For that matter the Federal Thrift Savings board itself is not diverse. Has there ever been an African American appointed to the Board? Why not? Diversity begins at the top.

Mr. Chairman , The Executive Director of the Federal Thrift Savings board should be challenged and directed to begin the diversity movement within his own office and staff and then in the various departments and division . This should be part of every vendors report the number of minorities that are employed and if there are none why and what recruiting efforts are underway.

Reaching these goals should be criteria for compensation at all levels beginning with the Executive Director of the Federal Thrift Savings Board and should be legislated as part of his job description and responsibility.

In closing the Federal Thrift Savings board should be about the federal employees and not just the administration of funds. The employees should be FIRST in the minds of the Thrift Savings Plan. Savings and investment education should be the top priority. With that education the Federal Workforce itself will force the Board to do a better job. Until the 1950s, only the wealthy could expect

to retire. In 1951, less than 5% of men said they retired because they wanted to rest and have some time off, and these were the men with the highest incomes. In that same year, over half of older men were working and most of the others were unemployed or unemployable.

Today, over 60% of older Americans, not working actually chose to retire because they prefer free time to paid work. Making retirement available to almost all workers, that is, "democratizing" retirement is one of the greatest achievements of robust market economies. Nonetheless, even in rich societies, conflict persists about who is entitled to pensions and how generous they should be. Reflecting on the debate over Americans' new social insurance programs—Social Security, unemployment insurance, and poor relief programs—philosopher Bertrand Russell wrote in 1935:

The idea that the poor should have leisure has always been shocking to the rich. . . . When I was a child, shortly after urban working men had acquired the vote, a number of public holidays were established. I remember hearing an old Duchess say, "What do the poor want with holidays? They ought to work."

The nineteenth-century duchess reflects a twenty-first-century conviction, deeply held in some circles, that because people are living longer, instead of society shoring up pensions, the elderly ought to work more. Indeed, if trends continue, sixty-five-year-olds in 2010 on average will live longer than sixty-five-year-olds ever lived before; however, perplexingly, the expected months in retirement will fall by 14%. People will live longer but they will work a whole lot more.

This committee can change that sentiment.

At this point Mr. Chairman I would like to stop, answer questions and submit the rest of my remarks for the record.

My home is Chicago, though I was born and raised in San Antonio, Texas. My parents and all my family always owned their homes. When they migrated from the country, or the farm, they came to the city to work. Many times they came to the city to work for the Federal Government. Maybe it was for the Post Office as a mail handler, or perhaps it was for a federal installation like Kelly Air Force base, building components for airplanes or other military machinery. My father worked very hard as a mechanic, and later served in the military in various overseas theaters of war; always a part of the federal employee workforce. Many of my family are proud to display similar experiences-------hard working Americans with faith in their country, their government, and the American dream. Many Americans have that same background. So, I commiserate with Americans like Sarah Harper, another person with family history rooted in the belief and fairness of our country, and the goodness of man despite the exceptions, who is today experiencing emotional setback and shock by what is happening with her investments; she's witnessing the chipping away of her American Dream of prosperity, spoken so eloquently about in the now famous Dr. Martin Luther King speech on the mall, in August of 1965.

Sarah Harper recalls that she once lived in a small, three bedroom brick house identical in layout to most of those on the block. The street was Roseland Avenue, a name that evoked more grandeur than it deserved. But it was her house -- the first and last home that her parents would ever own together. She recalled that she didn't remember much about moving there, but she did remember all that followed: the walk to the first day of kindergarten with her grand father; the smell of fresh jam made with moms tender touch in that avocado-colored kitchen, the sight of the moon while looking through a telescope with her dad; overnights shared with friends....dreaming about the future.

You see homes are unique in the specter of assets that we own; they embody our dreams, sorrows, and our achievements. They are both a nest for our children to flourish and a nest-egg for our futures. They are the largest asset that most people will ever own and as a result enable us to finance everything from cars to college degrees.

So, is our retirement savings? That is what we are talking about today, ladies and gentlemen, life savings, life savings, life savings in the Thrift Savings plan as it is affectionately called. It's personal ladies and gentlemen. It is personal.

Homeownership and retirement savings are inherent societal benefits. I remember as a young man launching my path in life, my mother said to me one evening "why don't you get one of those good government jobs." I knew much later that she said that because of the faith she had in the financial benefits received from a "good government job"--- benefits that I could count on.

Households who own instead of rent, and who save and invest at the lower end of the income strata, report lower rates of teenage pregnancies and higher rates of high school attainment------yet another reason why the downturn in home ownership and investment and savings in the marketplace is so tragic. It not only represents a hit to the economy, but it represents a hit to the American psyche. It is the straw that breaks the back of the working class households who feel that they have already given more than their fair share in an economy that penalizes manual labor relative to educational attainment. That is why the savings rate in America is so important. And that is why minority involvement in the investment process at all levels---from the seat at the table, to the perception on the street is critical. That is why involvement in the Thrift Savings plan is so significant. Mr. Chairman, if for no other reasons, inclusion without a doubt represents an ethical and business imperative. This effort can be a shining example of how the Social Security private account system my work as well should it becomes the law of the land as congress continues to look at the revision and improvement in benefits associated with the Social Security reform legislation.

THRIFT PLAN MODEL

Let's step back for just a very few minutes to review the Thrift Plan facts: The federal thrift plan was created as part of a 1986 reform of the pension for federal civil servants. It is modeled after the 401(k) plans available to many private-sector workers. Covered federal employees may elect to open an account with the thrift plan and have a portion of their salary allocated each payday to that account. The account can be invested in any combination of three thrift plan funds—one

tracking a broad stock index (the S&P 500), one tracking an index of fixed-income securities (Lehman Brothers Aggregate bond index), and one paying interest at the rate prevailing on long-term federal debt. At the end of March 2007, accounts in the federal thrift plan had reached an approximate total of $87 billion (U.S. Thrift Savings Board 2007b).

The chief attraction of the thrift plan is its low administrative overhead. Annual overhead charges come to roughly 0.1 percent of the value of the assets managed, which is generally viewed as about the lowest cost for which one could operate a system of individual accounts. Thrift plan management points out that these charges exclude the cost of enrolling and educating workers, tasks that are performed by the employing institutions. The TSP also incorporates a number of features that its proponents believe provide an adequate level of protection from political interference in investment decisions: (1) responsibility for operating the plan is lodged in a board insulated from political influence by having fixed terms of office; (2) members of the board must assume fiduciary responsibility for any decisions, meaning they can be personally liable for losses if they take actions not in the best interest of depositors; (3) investment options are restricted by law to a small number of funds indexed to match the performance of an index defined and calculated by a private-sector company; (4) money is actually managed by a private-sector firm selected by competitive contract; and (5) the investment management firm is required to comingle federal thrift plan monies with funds being managed for other clients.

It's important to know ladies and gentlemen, that the Thrift Savings Plan is not a panacea—yes; there are problems that need attention. In comparison with the 401(k) plans offered by many larger employers, however, the federal thrift plan has some significant limitations. One of the prices paid to achieve political insulation is that investment options are restricted to index funds. While historical experience suggests that index funds may yield higher returns than actively managed funds, the fact remains that under the thrift plan model there is no choice. Federal thrift plan costs are also held down by the existence of greater limits on fund switching than are found in many 401(k) plans. Participants can change their contribution allocations only every six months, during one of the semiannual open seasons. They can move money from one fund to another only once a month and only with at least 15 days' advance notice of their intention. Some of these provisions are under review by the Thrift Savings Board and may have been revised in recent years.

The federal thrift plan is also like a 401(k) in that workers have the options of withdrawing their balances as a lump sum at the time they leave employment (though they may have to pay a surtax if they are under age 59 and don't roll over the balance) and of taking out loans against their account balance.

Certainly the addition of investment options which are restricted by law to a small number of funds indexed to match the performance of an index defined and calculated by a private-sector company, warrants further discussion; particularly substantial discussion around the fact that the money is actually managed by a private-sector firm selected by competitive contract **which has never been opened up to minority owned and/or operated historically under- represented minority investment firms in this country----never been opened up to the minority owned and/or operated minority investment firms in this country Mr. Chairman.**

Even more critical is the fact that the investment or financial education of the various employees is inconsistent and lacking by the various agencies. Thrift plan management points out those enrolling and educating workers, tasks are performed by the employing institutions and frankly in adequate in preparing these individuals for retirement savings and distribution in today's economy.

On the one hand, there is the fear of political interference, usually articulated in the form of a general concern that the government would refuse to invest in tobacco companies, egregious polluters, or other enterprises that were deemed not to be politically correct. So, that is why there is the insulation from political involvement in the investment choice or event the investment companies experienced both here and abroad, which suggests that government interference or controls can have serious consequences for the investment returns on pension portfolios. A number of examples can be cited. In some cases, assets have simply vanished. Even among the better-run systems, returns have not always been as high as would be suggested by market experience.

If you want to avoid putting all your eggs in the one basket of a particular company's shares, it is possible instead to spread the risk of your investment by pooling it (with other investors) into a range of different investments. In this case, the pooled investment is managed by a professional fund manager, who makes decisions on the range and types of investment. Such collective schemes fall - again, broadly - into three different types: unit trusts, investment trusts and Open-ended Investment Companies (OEICs).

Once you have reached this level of investment decision-making, however, the vast range of unit trusts, investment trusts and OEICs available can open up a veritable Pandora's Box of choices. In order to avoid making potentially very costly mistakes or rash investment decisions; this is the stage at which - if you have not done so before - you should consult an independent financial adviser.

Financial investment advice is wisely taken because of the sheer range of investment decisions. That is where the professional investment advisor comes in.

I am quite aware that almost every decision an individual makes involves risk of some sort. This is especially true in the government labor market where individuals choose career paths, decide about changing jobs, and make decisions about the form of their compensation. The common stereotype is that women are more risk averse than men. Risk adverse behavior in the government labor market may lead to a choice of job with a lower mean and lower variance of salary. Or lower investment potential. If indeed women choose less risky investments, this can explain in part the gender gap in investments. It's the same with racial groups Mr. Chairman.

Even if there were no actual differences in gender or race attitudes toward risk, the belief in the stereotype may by itself have implications for what investment products are offered. **Thus the importance of inclusion Mr. Chairman ; inclusion on all levels, from investment advice to investment management.**

That inclusion has to be a guiding principle of the Federal Employee Thrift Savings Plan.

I would like to suggest that certain ideas from the economist '

Teresa Ghilarducci who wrote the book **When I'm Sixty-Four'**

Be considered. She is a professor of economic policy analysis at the University of Notre Dame, where she specializes in pension benefits. She is also the director of the Higgins Labor Research Center and a Wurf fellow at the Labor and Worklife Program at Harvard Law School.

Her book explores the basis of the belief that the elderly have too much retirement leisure; and asks the question, Who loses and who wins if and when pension income becomes less secure and the elderly work more as a consequence?

Older people, who must work longer than they want to make ends meet, lose. Employers, who avoid raising wages as older workers stay in the labor pool, win. Financial managers, eager to manage individual retirement accounts, defined contribution or 401(k)-type plans, which could be newly created from converted traditional company pensions (defined benefit plans) and privatized Social Security, also win.

This book also covers the sources of retirement income, the distribution of retirement time, and ways to rescue the pension system.

This opening chapter argues several issues: that civilized societies enable people to retire; that the United States has achieved much toward ensuring entitlement to retirement for ordinary workers; and that moves toward individual retirement accounts—defined contribution pension plans, 401(k)-type pension plans, and Social Security commercial personal accounts—are flawed responses to pension troubles and to the decreasing ratio of workers to retirees.

The financial industry and political groups, devoted to making government smaller, promote the replacement of employer pensions and Social Security accounts with individual accounts—while ignoring what public policy has accomplished for retirement security. Their vision of a reformed U.S. retirement income system moves away from what good reform should do—that is, make the system more fair, enhance productivity, and be more efficient. No pension system should waste people's money.

Principles for a Pension Rescue Plan

In 1960, half of the nation's private sector workforce and almost all of the public sector were covered by a traditional pension plan, commonly referred to as a defined benefit pension plan. Forty-seven years later at the beginning of the twenty-first century, the same share of the private sector workforce is offered a pension plan at work. But the type of plan they are offered has changed dramatically: the defined contribution 401(k)-type individual account plan is now dominant. Public sector workers still have defined benefit plans.

There are many differences between defined benefit and defined contribution plans. One is particularly stark: In defined benefit plans, employers make all the investment decisions and must pay the pension regardless of the pension fund's investment earnings. In a defined contribution plan, the employee makes all the decisions and accepts the risk that the accumulations in her account could be lower than expected. Here is how the plans work.

A defined benefit (DB) pension plan credits every year of service with a certain percentage of salary earned, which is usually some average of the salary over the final years on the job. For example, a typical defined benefit plan pays a retiree an annual benefit equal to 2% for every year of service multiplied by an average of the last three years of salary. Therefore an employee who earned, on average, $40,000 in his last three years of his twenty-year service would have an annual pension of $16,000, calculated as follows: 2% of $40,000 is $800; twenty years at $800 per year of service is $16,000. That annual pension payment comes to 40% of the $40,000 average of the last three years' annual earnings. (Keep in mind that 40%!) The employer contributes annually to a fund to pay for these defined benefit pensions as they come due, according to federal regulations.

In a defined contribution (DC) plan, the employee and most employers pay a defined amount into the employee's individual retirement account. Whatever the account accumulates and earns on its investments is what is available. A savings account and an individual retirement account are fairly similar, except an individual is advised to invest the retirement account in many different investment vehicles and there are certain rules about withdrawing money from it. A worker can borrow against or withdraw funds from her or his retirement account before age fifty-seven-and-a half, but must pay a tax penalty—a 10% tax rate is added to the employee's ordinary federal tax rate—on the amount of funds withdrawn. Many employees do withdraw their money and pay the tax penalty. Until the 1990s, defined contribution plans were mostly used as supplements to defined benefit plans. Now, many companies have replaced their traditional pension plans with defined contribution plans.

As 401(k) plans overtook traditional company pensions, Social Security emerged as the only reliable source of income for the elderly. During the same time period, wage income emerged as the elderly's fastest-growing source of income. As you will see, this means that more of the elderly will be poor, and many more of those who don't fall into poverty will experience a significant fall in living standards after they retire.

Making people work longer and look for work at older ages to augment inadequate pensions may be a reasonable proposition. But to ensure that older people freely choose work over retirement and that future generations are not downwardly mobile, facing a retirement future as bleak as retirement was before the 1970s, the following needs to happen:

Workers must be required to save 5% of their salary (up to the Social Security earnings cap) in a guaranteed retirement account. The accumulations in these accounts should become available after age sixty-five; the government must guarantee the rate of return; and a government agency, not a commercial money manager, must administer the accounts.

Tax subsidies for 401(k) plans must be replaced with a $600 refundable tax credit for each worker, to help offset the financial sacrifice of having to save 5% of earnings. The replacement will equalize government tax subsidies between high- and low-income earners.

Social Security payroll tax increases must be scheduled for 2020 and general revenues—from the estate tax particularly—used to eliminate old-age poverty.

Worker representation on employers' pension boards should be mandatory. This will help workers save because they will be engaged in the management of their money; worker representation will also inhibit employers from managing the company's pension plan to serve their own interests.

These policies could make it easier and less costly for anyone, especially low- and middle-income workers, to save for retirement. More importantly, these changes would avoid the problems of the narrow interests of the financial industry and having employers steering pension reform. Historically, workers have better pensions when both their political influence and their bargaining power are strong, and when workers feel entitled to income and leisure after a lifetime of hard work.

The Successes of the U.S. Retirement System

So far, at the beginning of the twenty-first century, Americans expect time off at the end of their working lives. Americans consider that it is reasonable to expect paid retirement time—a concept that has evolved, just as the entitlement to any time off has evolved, as implicit in overtime, the eight-hour day, and "the weekend." These entitlements resulted from compromises between workers,

organized labor, firms, and federal and state governments. Workers throughout the post–World War II period have continued to want, and to pay for, holidays and vacations, paying in the form of forgone increases in cash wages and/or increased productivity. The New York City transit workers risked public ire and severe consequences when they stranded millions of commuters in chilly December 2005 in a strike over a proposed cutback in their pension benefits. Not only is entitlement to paid time off important, American workers and their unions have come to regard pension plans as a way for ordinary workers, many of whom are and were immigrants, to achieve middle-class status by obtaining some of the same kinds of income security arranged for their managers and bosses.

Gains in retirement time were quite large before the start of the twentieth century (before the year 1900).Men born after the Civil War lived much longer—their average time in retirement leaped approximately 9% compared to men born five years earlier (these calculations are explained in chapter 2). From 1900 to 1999, the largest gains in retirement time were for those people born around 1911; women enjoyed a more than 12% boost in retirement time compared to women five years older, and men an 8.2% boost.

This age group retired in the mid-1970s, when Social Security benefits increased rapidly and company-provided pension plan coverage was growing. The rates of increase in retirement time for each successive group of people born five years later gradually fell; the increases may have gotten smaller, but they nevertheless were increases! Not until the late 1990s did the growth in retirement time begin to turn downward. Both men and women retiring around 1999 could expect less retirement time (about 1% fewer years) than people just a few years older. Clearly, people are living longer, but they seem to be using the longevity increases to engage in paid work, not to experience retirement leisure.

Perhaps workers are freely choosing to use their longer lives to work more. Or it could be that people increasingly feel forced to work longer because their retirement income has become less adequate and secure. The reality is somewhere in between. And because the gap in retirement leisure between different groups is growing as middle-class retirees and lower-income retirees suffer from less secure and smaller pensions, the changes are hurting some groups and helping others

Again, Even if there were no actual differences in gender or race attitudes toward having a pension and the risk associated with it, the belief in the stereotype may by itself have implications for what investment products are offered. **Thus the importance of inclusion Mr. Chairman ; inclusion on all levels, from investment advice to investment management.**

That inclusion has to be a guiding principle of the Federal Employee Thrift Savings Plan.

Thank you for your time. I would be happy to answer questions now or at a later time.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Brown.

Let me thank all three of you for your testimony.

As we pursue change and as we continue to move, it struck me that change is often a slow and subtle process. It also struck me that change is often more covert than it is overt; that it is more evolutionary than revolutionary.

As I was thinking of that, Mr. White, I wanted to ask you do you think pursuit of a more active strategy on the part of the Thrift Board would constitute a breach of fiduciary responsibility?

Mr. WHITE. Well, the short answer to your question, Mr. Chairman, is absolutely no. It would not be a breach of fiduciary responsibility. Again, as I mentioned, many, many U.S.-based plans, both defined benefit as well as defined contribution, have both active as well as passive management as part of their overall asset allocation.

It was interesting when Representative Norton asked Mr. Long the question earlier about benchmarking, and benchmarking the TSP versus other similarly sized pension plans, and why that doesn't occur. Certainly, if one were to do that survey, I think you would find that plans of that size, with exclusively passive investment as well as a single manager are probably in the minority among any similarly sized plans within this country, and perhaps even worldwide.

Mr. DAVIS OF ILLINOIS. Ms. Hobson, let me ask you, given the experiences of Ariel, given its success, given the approach that it takes, and as you look at the scenario of TSP, its statutory requirements, its investment approaches, do you see any minority firms that you think could handle at least a substantial piece of investment for the TSP?

Ms. HOBSON. The way I would answer the question is this: I think that no minority firm could handle the entire Plan; it would not be possible. But I do think that a number of minority firms can participate in helping to manage the assets for the existing Plan participants. Moreover, I think the participants would welcome more choices. And at the end of the day, that is all you are doing, is giving people another choice; and at the end of the day they vote with their feet based upon the actual performance results of the funds.

Mr. DAVIS OF ILLINOIS. Not that you necessarily delved into every aspect of the TSP, but just given what you know about it and about its statutory requirements and all, do you think that they would have the authority to let such a piece of action, where they kind of broke things up some.

Ms. HOBSON. I absolutely think they would have the authority to expand and include more firms in the current process than what currently exists with the sole provider, being Barclays. I also think that, again, when you look at benchmarking of other plans, I am not sure that there are many plans around the world that are of this size.

So it is hard to go apples to apples in terms of the pure scale of this Plan. But when you do look at very large defined contribution plans around the country, many of whom we work for, the biggest in the country, the United States, when you look at those plans, you do see more options, more opportunities, and you tend

not to see a solely indexed option or set of options for the plan participants. So you can look at, again, major, major corporations and see that there is a more diversified lineup of offerings.

The TSP, from what I understand, will use the cost argument as their major defense—that is what I would assume—and say we get to do this at the lowest possible price. We would come back and argue that you may be giving up investment results in exchange for that 1.5 basis point fee, which I am not sure that is all-inclusive in terms of the costs, but we would say that there may be more upside for your participants in terms of more offerings. And again, at the end of the day—I cannot emphasize it enough—they get to vote with their feet; they get to go where they want to be, look at the returns of the funds side-by-side and decide to invest in that manner.

Mr. DAVIS OF ILLINOIS. Mr. Brown, let me ask you. In your testimony, you talked a great deal about change, and I know that you were present as other witnesses testified and as we talked about different possibilities and different ways of changing the activities of the TSP. You even mentioned the board and the whole diversification effort.

What would you view as an option? Obviously, we are searching for ways to change the way the TSP operates, not because we are just opposed to the way that they may operate, but because we believe in fairness, we believe in equity, we believe in open opportunity. So what would you view as something that we can do legislatively or that we can do from the vantage point of this subcommittee?

Mr. BROWN. Mr. Chairman, the law is rather specific as to what can and cannot be done, so obviously the most specific thing is to actually look at the legislation itself. The way the law is put together, it gives a tremendous amount of authority to the Federal Thrift Savings Board, those individuals who are appointed by the President and, in some cases, with the advice and consent of the Speaker and the Majority Leader or the Senate. So although the committee may have an interest in doing one thing or another, the original law has some handcuffs, if you will.

Specifically in terms of diversity and change, the suggestion that there be other funds allowed in the mix of funds of the Thrift Savings Plan is something specifically that this committee could suggest. In the past, there have been suggestions, as you indicated earlier, that various other types of investments—commodities, real estate investment trusts, precious metals; the list goes on—the Federal Thrift Savings Board has the ultimate responsibility in making this decision, but certainly the committee and Congress can make those suggestions. So I think that is one very specific thing that you might want to look at.

In terms of the management of the funds, the Federal Thrift Savings Board has responsibility of actually just kind of managing the funds itself. That is kind of administrative role more than actually passive-active. They administer it. The Board makes the decision as to what choices are going to be in the Plan. Actually, the Board, a year or so ago, moved toward a lifestyle set of funds in addition to their lettered funds for bonds and equities and such. So I would think that this committee has a tremendous responsibility in that

regard in terms of making that suggestion to the Federal Thrift Savings Board.

So, in summary, it is the Board itself that really requires some attention, and until that Board is dealt with, then it is going to be very, very difficult, even at hearings like this, to make any kind of change because of the cushion that was given to them in terms of political intervention.

Ms. HOBSON. If I could respectfully also add to that, in terms of how the Board considers the provider for the plan. In many situations, and Ariel very frequently responds to proposals, fills out requests for proposals from city and State pension funds around the country, as well as defined contribution plans, and in those RFPs there are specific questions about the diversity of the organization. And while there is no mandate or requirement around any kind of diversity, by mere virtue of asking the question, it does behoove people to want to answer the question in a way that shows off their firm in the best light. When all things are considered and firms are set side-by-side, perhaps it will add one more opportunity for consideration or actually being selected.

So I would use that as a means of saying while not legislating it, when the RFP is written again, 3 years from now, when the contract ends, that there might be a conversation about adding to that RFP discussions about the diversity of the provider, as well as their board of directors. As far as we can tell from our research, there is no diversity on the board of the current provider, none, and no diversity, as far as we can find, in terms of the upper management ranks of the provider. And while we do not say that in a way to pass judgment, we say it in a way that the question at least should be asked.

Mr. DAVIS OF ILLINOIS. Let me just agree with you, because I kind of liken this to the merit selection of judges, and we used to laugh about it in terms of who was determining that some people had merit and other people didn't. And then we decided to change the system and found out that a lot of people have merit, and it is very possible that the chief judge of our court system may not have become a judge if we had not moved from the way that this notion of merit selection, where insulated groups were making determinations about the credentials and viability and possibility of lots of other people.

Let me ask this. Legislating is not the easiest thing in the world. I mean, there are many factors that always contribute to legislative determinations and decisionmaking, and people who are defenders of the system, they like the idea of suggesting that there is some insulation from politics, that they really don't have to be concerned about external pressures, I guess, or efforts of external intervention. And when I hear that, I am always reminded that you can't always determine what goes on around you, but you ought to be able to determine how you react and respond to it.

Also, how do you think—and each one of you, if you would, and perhaps this will even be our last question—how do we maintain the integrity of systems and at the same time try and move them toward the inclusiveness that we all talk about and hope to see and fight for, and still maintain what would be called the integrity of a process involving investment of these huge sums of money?

Mr. BROWN. Mr. Chairman, one idea is the inclusiveness that the legislation speaks of in the first place, and that is to say open it up, allow different types of investments to be included in the Plan. Now, what we have now is a very narrow set of things that is possible to be invested; there are index funds and they are just very narrow.

Now, the problem with opening it up, of course, is opening it up, and there would be opportunity for all these various other funds, be it real estate investment trusts or commodities, or this thing or that thing or another, and that could become unmanageable, but it certainly would be open. Once it is then open, then, obviously, there will be opportunities for different types of managers for different types of things. So, obviously, a particular manager might be good at fixed income or another particular manager might be good for one thing or another.

I think there will be great resistance to this because it would be so open, but there are—and I think Mellody kind of commented on this—there are various plans, 401(k) plans and others, around the country that would give you a list of 20, 30, 40, as many different opportunities as possible. And as I think she indicated, people vote with their feet, they pick one fund versus another fund. Sometimes they pick the wrong one; sometimes they pick the right one.

Mr. DAVIS OF ILLINOIS. Well, that is what the TSP people would say that they are trying to make sure does not happen.

Mr. White.

Mr. WHITE. Yes, Mr. Chairman. A couple of things I might just point out. One is somehow this idea that active management is both political and/or social is just flat-out wrong. There is nothing inherently political or social about active management. It is not any more politically involved than passive management. So there is nothing inherently social or political about either.

As was mentioned in an earlier panel, the key ought to be how do we maximize returns for participants. That ought to be the driving force. Certainly, in addition to considerations about costs being written into the legislation, the flexibility to include active management, also considerations about risk and return ought to be included within the legislation. Those are ways that traditional, well-run, fiduciaraly sound plans, whether they be defined benefit or defined contribution, typically include these kinds of considerations as they make decisions about who manages assets.

I think, finally, this idea of having processes like competitive bid, RFP, the use of external consultants. The Thrift Plan mentioned that they had used Ennis Knupp, which is a consultant for many of the large plans that we work for and others. Again, these are all mechanisms to help maintain the integrity of the decision-making about who gets to manage assets, so these are things that can be built into legislation to help ensure the integrity of the process.

But there is nothing inherently political or less political about a passive strategy versus an active strategy. Just if I might add parenthetically, one might view a single provider for a plan that large as some political sweetheart deal. I don't necessarily think that because I think Barclays is a good firm. But the fact of the matter is, again, single manager risk, specific company risk, particularly

with a firm whose parent is a U.K.-based entity, and not a U.S. entity, I think creates a lot of undue risk for participants. Certainly, as we have seen with other large plans over the past year or so, things happen with large investment firms that none of us could anticipate.

Mr. DAVIS OF ILLINOIS. Well, thank you very much.

Ms. Hobson.

Ms. HOBSON. Yes. My add-on comments to very, very good perspectives are, one, we are not talking about revolution here; we are talking about some incremental change. I would not sit here and tell you that it is a bad plan; I am just saying it could be slightly better if there were more participation and more inclusion. I would not ever advocate 20 mutual funds. I would not ever advocate a fund for every flavor and topic, because I think people then become overwhelmed with the choices that they get. But I do think, on the margin—again, not anything revolutionary, but more evolutionary—there is an opportunity here to make the fund slightly better, the Plan slightly better.

The one way to de-emphasize any of the political conversation that you are alluding to is, at the end of the day, in our business, the really great thing is we have a score. We know who did well and who didn't. You can look at the numbers on the page every single day in our business, every single day you can open up the newspaper and see how your Ariel mutual fund did, and we know if we won or lost that day versus the indices that are in this plan. So the good news is that de-emphasizes any kind of political conversation because the numbers speak for themselves. And at the end of the day, as I said before, people will go where the performance is, which is also not political at all; it is in their own best interest.

Last but not least, when you look at any of the other plans that are out there, you typically don't see this. And if we take it a step further and look at other Federal plans like the National Railroad Retirement Trust, as an example, it has active management in it. So you can't argue the political active management discussion for one plan and not have that same argument apply to another. So I would hold that up as an example that would perhaps put a pin in that issue very quickly.

Mr. DAVIS OF ILLINOIS. Well, let me just thank all three of you, as we begin to adjourn.

Did you have another comment?

Mr. BROWN. Yes, just one very brief comment. The difference between the Thrift Savings Plan and other pension plans is that the individual employee makes the decision for himself as to what is going to be in his particular account. So one of the failures of the Federal Thrift Savings Board and the Thrift Savings Plan is the education or better education of the actual participants itself. Many times they push this off to the Office of Personnel Management, who is not here today, and that might be another consideration of the committee, to talk with them at some point.

Mr. DAVIS OF ILLINOIS. Well, thank you all so much. I want to thank all of the witnesses. I also want to thank all of you for coming.

I am reminded of two things. One, a fellow named George Collins, who used to be the Congressman representing the district that

I represent. One of the first political speeches that I ever heard George make, he said that the politician, Confucius said, that he who tooteth not his own horn will find that same shall not be tooteth.

I have sat through many hearings. I can tell you that there are more Black-Americans in this room than most hearings I have attended since I have been a Member of Congress, when the room was overflowing. So I am appreciative of the fact that you are here and that you are expressing the interests and displaying the expertise that you have. Oftentimes, there are no minorities even on panels testifying. There is nobody, seemingly, that is a minority that is often asked to testify. So the perspective that we often get is not one that contains the experiences of minority elements of our population community.

So I want to thank you all for coming. I want to thank the staff for the outstanding work that they have done in putting together this opportunity. And with that, this hearing is adjourned.

[Whereupon, at 12:37 p.m., the subcommittee was adjourned.]